

FIRST GLOBAL

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India Research



Sector: Retailing

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

***Who will survive –
Organized Retail or Kirana stores?***

including

Comparison on operational performance

plus

The critical success factors

April 13, 2007

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Research Note issued by First Global Securities Ltd., 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 – 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'?
How lucrative is FDI in Retail for India?**



Organized Retail v/s Kirana store

This report is the third part (Part III) 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 have done a comprehensive analysis of Organized Retail store in a mall and Kirana store. We have also analysed the critical success factors for a Retail store as well as a Kirana store and the expected scenario in the coming years.

More and more companies, both domestic as well as global, are keen to capitalize on the consumption led growth of the Indian economy and enter the domestic Retail sector. With such massive prospective investments of Rs.840bn (Please refer Table-I) by the retail companies in the domestic retail sector, many more Organized Retail stores are expected to be operational in the coming years.

TABLE – I	
Expected upcoming Investments by 2010-11	
<i>Retail Players</i>	<i>Amt. (in INR bn)</i>
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*

As we concluded in Part I of this series, the most critical determinant for the organised retail market to grow is the ability of Organized Retail players to attract the unorganised retail customers. This, more than the aggregate market growth, will determine the future outcome for organised retailers. In order to analyse, if at all the organized retail players (in the value-retailing segment) will be able to attract the unorganised customers by providing them value, we have undertaken a comprehensive comparison between an organized retail store and a Kirana store (the unorganised sector grocery store). We have also analysed the critical success factors for both an organized retail store and a Kirana store and the road ahead in the domestic retail sector.

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The Operational Performance

In order to have a better understanding of the operational performance of an Organized Retail store and a Kirana store, we have compared the profitability of organized retail store, Kirana store and a stand-alone supermarket (or large/upgraded kirana stores).

We find that although the organized retailers enjoy much lower cost of goods (as compared to the kirana stores and supermarkets), primarily due to their large scale of operations, Kirana stores operate at a much higher operating margin

We find that although the organized retailers enjoy much lower cost of goods (as compared to the kirana stores and supermarkets), primarily due to their large scale of operations, Kirana stores operate at a much higher operating margin.

A typical Kirana store caters to the requirements of its customers in a confined area or locality and works at quite low operational scale, due to which the cost of goods is much higher as compared to a retail company. On the other hand, a high operational scale aids the organized retailers to record lower cost of goods. Due to such large scale of operations, the super market or the organized retailers are able to offer goods at a discount to the customers, as compared to a typical kirana store, which offers goods at the MRP (Maximum Retail Price). The kirana store, which lacks the operational scale, does not get any discount from the distributors and thus does not pass any such benefits to the customers. However the organized retail stores or supermarkets, which get benefits (in terms of lower sourcing cost) due to their operational scale, pass some of the benefits to the customers (in the form of discounted goods to MRP).

TABLE – II			
Comparison of the operational performance of a Kirana store (in a metro) and an Organized Retail store			
PARTICULARS	<u>Kirana Store</u>	<u>Super Market*</u>	<u>Organized Retailer#</u>
REVENUE	100 %	100 %	100 %
<i>Less:</i>			
Cost of goods	88-90%	82-85%	75-78% ¹
Employee salary	2-3%	5.5-6.5%	6.5-7.5%
Administrative cost (Includes lease rentals for shop and godown)	1.0-1.25%	1.0-1.5%	1.5-2%
Marketing & Promotional expenses	-	~0.5%	7-8% ²
Other Expenses	~0.5%	~1%	1-1.5%
EBIDTA Margin	8-10%	7.5-9.5%	7.0-8.5%

* Includes big Kirana Stores, which have reasonably large scale of operations.

Only Value retail stores like Big Bazaar, Vishal Megamart etc are considered

1. The cost of goods includes the logistics cost (from company's warehouse to its own store). However a Kirana store does not incur such expenses since the distributors supply the goods directly whenever required.

2. Marketing & promotional expenses are incurred both by the retail company as well as the specific retail store.



Kirana stores enjoy much lower overheads, primarily employee cost, selling and distribution cost and lease rentals, as compared to organized retailers, which gives them an edge at the profitability front. On the contrary, a higher employee requirement (both on-store and home delivery employees) and the scarcity of right talent led to an increase in the employee cost for both organized retailers and to some extent, supermarkets as well.

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In order to attract customers, the organized retail players need to spend substantially on the advertising and promotional expenses. Moreover a boom in the real estate prices and lack of right location (discussed later in the report) has also led to a rise in the lease rentals, which have an adverse impact the margins front. However a greater proportion of private labels,

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We believe that the kirana stores and supermarket may not be much different at the margins front, since higher operational cost negates the benefits for operational scale for the supermarkets. However the supermarkets, as compared to kirana stores, are in a much better position to play on volumes and thus capitalize on their existing infrastructure.

The kirana store or supermarket (to some extent) does not have much financial leverage, which aids

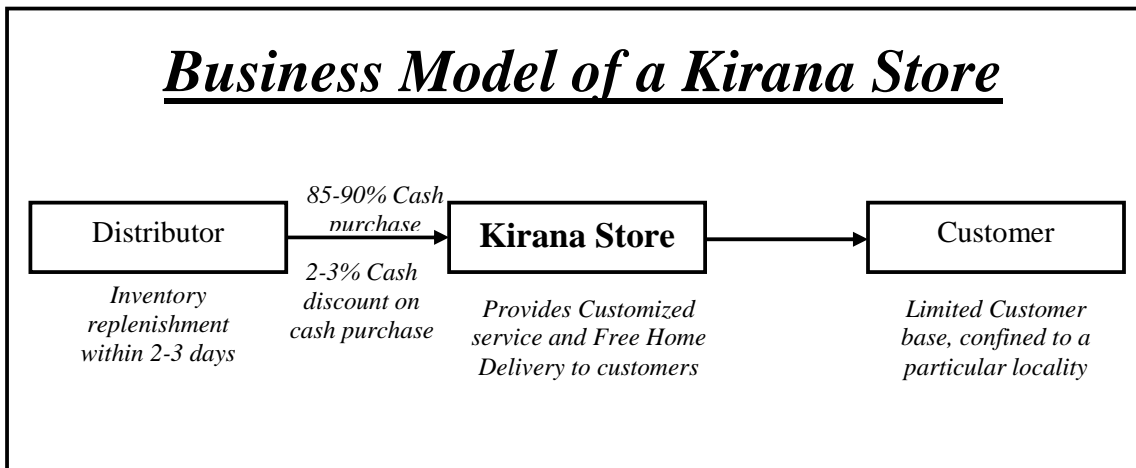
the EBIDTA margin to be carried forward to the net profit margin. However in case of an organized retailer, a higher interest outgo, due to comparatively higher leverage, eats into the net profit margins. Moreover kirana stores operate in an unorganised market, where the parallel grey market (unaccounted revenues) leads to tax evasion, which further aids the bottomline growth. However in organized retail stores, (white market) record high taxes, which further leads to a decline in the already low margins.

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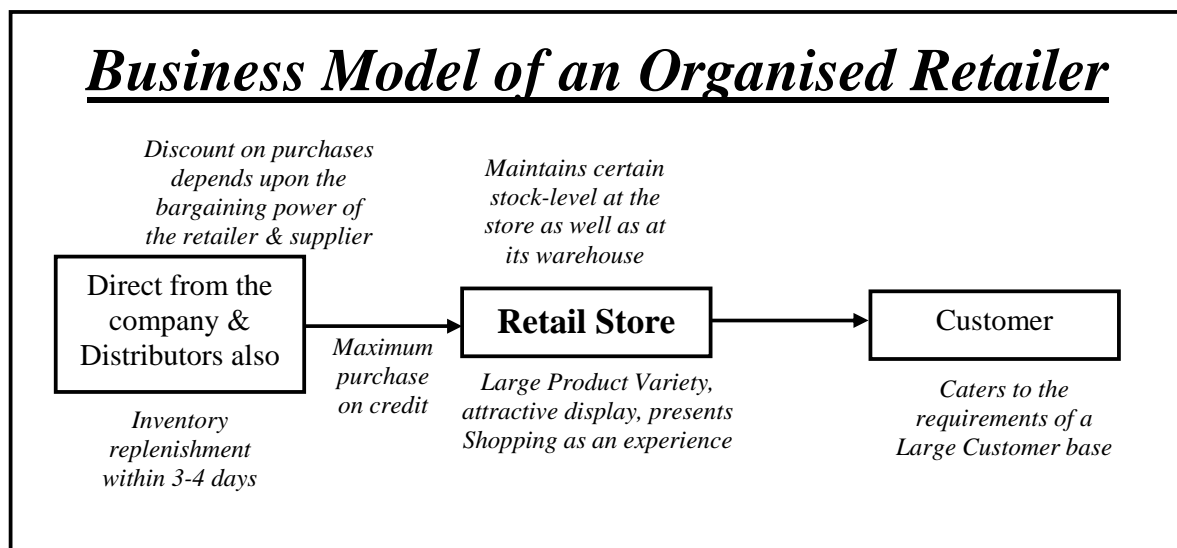
The Business Model

A Kirana store operates at a small operational scale and caters to the requirements of a particular area or locality. It sources its goods from the distributors of respective companies and can place a replenishment order whenever required (generally a distributor takes 1-2 days to replenish the stock). A Kirana store has a limited product variety, but provides customized service and free home delivery service to its customers.



Source: First Global Research

On the other hand, an organized retailer provides a large product variety and presents shopping as an experience to its customers. A majority of its sourcing is directly through companies. Every retail company manages a warehouse to store inventory, sufficient inventory to meet the expected customer demand. The inventory is replenished at an average 3-4 days from the date of order. Although the retail companies do not provide customized service, they do declare frequent promotional schemes to attract more customer traffic.



Source: First Global Research



Other differentiating factors

TABLE – III		
<u>PARTICULARS</u>	<u>Kirana Store</u>	<u>Organized Retail Store #</u>
<u>PRODUCTS:</u>		
Minimum Retail Area (in sq ft)	200 - 250	2000 - 2500
Variety of products	<i>Limited</i>	<i>Reasonable</i>
Product Display	<i>Normal; usually not customer accessible</i>	<i>Attractive; 'touch & feel' available for customer</i>
Private Labels	<i>No</i>	<i>Yes</i>
Sourcing of goods	<i>Distributors only</i>	<i>Distributors as well as direct from the company</i>
Mode of purchase of goods	<i>90-95% cash purchase</i>	<i>Majority credit purchase</i>
Cash Discount (from suppliers)	<i>Cash discount of 2-3% on cash purchase only</i>	<i>Depends on the bargaining power of the retail company and the supplier</i>
Inventory loss due to breakage/pilferage	<i>0.5-1%</i>	<i>~1%</i>
Average Inventory replenishment time	<i>1-2 days</i>	<i>3-4 days (depending on the company's sourcing model)</i>
Stock maintained at any separate warehouse	<i>No (In-store storage only)</i>	<i>Yes</i>
<u>SERVICES:</u>		
Value-added services like home delivery	<i>Yes</i>	<i>No*</i>
Customized services	<i>Yes</i>	<i>No</i>
Shopping Time	<i>Minimal</i>	<i>Substantial</i>
Frequency of shopping	<i>Frequent</i>	<i>Not frequent</i>
Special Promotional offers	<i>Only if declared by the distributor</i>	<i>Frequently, declared by the retailer (owner company) also</i>
Cash Discounts (to customers)	<i>Yes (depending on the amount of purchase)</i>	<i>No</i>
Provide shopping as an experience	<i>No</i>	<i>Yes</i>

Source: First Global Research

Only Value retail stores like Food Bazaar, Reliance Fresh etc are considered

* Available only in some retail outlets and that too depending on the amount of purchase.



The key benefits & drawbacks

Organized Retail Stores

The key benefits ...

- 1) The Organized Retail stores (typically situated in Retail malls) offer a large variety of products across all categories.
- 2) The Organized retailers do maintain some minimum quality standards for their products, especially food and groceries, which aids the company to provide quality products at a reasonable cost to its customers.
- 3) In order to attract customers, the organized retailers quite often declare some promotional offers, which provide the customers a bargain.
- 4) The organized retailers not only offer products and services, but also offer a complete '*shopping experience*' to its customers. The retail malls not only provide an opportunity to shop, but with multiplexes and food courts, the retail malls provide a complete *family outing* solution.

The drawbacks...

- 1) The organized retailers do face the problem of low conversion ratio, since most of the persons visiting such stores are not serious customers. A lower conversion ratio leads to slow growth in the topline, as compared to the growth in the footfalls.
- 2) Due to a large customer base, the organized retailers are unable to provide customized service to its customers, as compared to the Kirana stores.
- 3) The organized retail stores/malls have to bear the burden of high maintenance cost (especially display and decoration etc) and employee cost due to its huge size (almost 10 times of a normal Kirana store).
- 4) In case of any complaints, it may take some time for the customer to solve his problem due to the bureaucracy involved in the organized retail store. However, in case of a Kirana store, there is a direct and on-the-spot solution, since the owner is in direct contact with the customer.
- 5) The organized retailers focus mainly to provide value to its customers, primarily by providing reasonable quality at low prices. However sometimes, too much focus on maintaining low cost may lead to a lack of focus on the product quality, which may hamper the retailer's goodwill.



Kirana Stores

The key benefits ...

- 1) The Kirana stores provide a customized service to its customers. Since most of the Kirana stores cater to the requirements of a confined locality or region, they are able to customize their service as per the requirements of the customers.
- 2) Almost all the Kirana stores provide the service of free home delivery. The Indian consumer still does not prefer to go for shopping and prefers to get his/her goods delivered at home.. Although a few Kirana stores do have some minimum purchase (like Rs.100) criterion for free home delivery, however most of such Kirana stores provide a free delivery of goods, irrespective of any amount of purchase, especially to regular customers.
- 3) Since the Kirana stores operate on a small scale, they have low maintenance and employee cost, which aids them to break-even much more quickly, as compared to a normal organized retail store, generally situated in a Retail mall.
- 4) The Kirana stores generally maintain a low inventory level, as the inventory is readily available with the distributors, which is generally replenished within 2 days.

The drawbacks...

- 1) The Kirana stores generally operate at a low operational scale. This leads to a comparatively higher cost of goods for the Kirana store operators (as compared to an organized retail store) due to much smaller scale of operations.
- 2) The Kirana stores operate in a confined region and cater to the needs of a particular locality. This leads them to a limited scope for further growth in the business, (especially the topline growth). Even opening new stores may not be a feasible option, due to limited family members (since most of the kirana stores are family owned and managed), which is one of the key distinguishing factors for a Kirana store.
- 3) The Kirana stores operate at a small scale and a minimum inventory level. An average Kirana store does not offer much product variety for its customers.



The Critical Success Factors

Organized Retail Store

Right Placement of the organized retail store: There are some key factors that have a direct impact on the topline of any organized retail company. One such factor is the availability of the right location for any retail store, so that it is able to attract significant customer traffic. 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 sector. A right organised retail store location will attract much greater customer traffic and will aid the company's topline growth.

Attract the unorganized retail customers: The biggest challenge that the organized Indian retail sector is facing is to attract the customers of the unorganized retail sector. The Indian Retail sector is estimated to be around Rs.360bn as of now and is expected to reach Rs.1200 bn-Rs 1550 bn by FY2011. As we showed in Part-I of our retail series, the ability to do this will be the single biggest determinant for the success of this sector. (Please see Part-II of our *The First Global's Series on the Indian Retail Sector*).

The biggest challenge that the organized Indian retail sector is facing is to attract the customers of the unorganized retail sector. The Indian Retail sector is estimated to be around Rs.360bn as of now and is expected to reach Rs.1200 bn-Rs 1550 bn by FY2011. As we showed in Part-I of our retail series, the ability to do this will be the single biggest determinant for the success of this sector

Considering the price-sensitive nature of the Indian consumers, we believe that the domestic retail companies will have to deliver value to the Indian customers by providing reasonable quality products at low price. Moreover a better shopping experience, primarily in the form of better product variety, entertainment, no long billing-queues etc will add further value to the customers.

Efficient Inventory management: Inventory plays a crucial role in the success of any Retail store. An efficient inventory management system, especially the procurement and replenishment system assures a steady supply of goods. It is quite essential for any retail store to have a sufficient inventory level to meet the customer's requirements and at the same time, not pile up too much investment in inventory.

Sourcing of low price-high quality products is equally important for the 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 FY07.



Managing margins: At present, almost all the retail companies are facing pressure at the margins front, primarily due to an increase in operating cost, especially employee cost and selling and distribution cost. The rise in employee cost (both at the store and in the form of corporate overheads) is primarily due to shortage of talented and skilled manpower in the industry, which is a

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... 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. A shift in the revenue-mix from lifestyle retailing (apparels, footwear etc) to value retailing (food and groceries) will add further pressure at the margins front

typical trait of a fast growing 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. A shift in the revenue-mix from lifestyle retailing (apparels, footwear etc) to value retailing (food and groceries) will add further pressure at the margins front. We believe that with the entry of industry majors like Reliance, Bharti-Wal Mart and A.V.Birla group, the competition is bound to intensify, however in order to create value for the investors, it is quite pertinent for the retail companies to sustain its performance at the margins front in the coming years.

Kirana Stores

Customized services: A Kirana Store operates in a confined region and caters to the customer requirements of that particular locality only. With such a limited customer base, it is very easy for the Kirana shopkeeper to provide customized service to its customers and know about their tastes and preferences. However the same may not be an easy task for an organized retailer, since he has a more widely dispersed customer base. Infact such a customized service is one of the key success factors for any Kirana storekeeper as it aids them in giving a personal solution to the customers' requirements.

Home Delivery facility: In order to facilitate its customers, a Kirana storekeeper provides certain value-added facilities like free home delivery to its customers. Although some Kirana storekeepers provide such a facility only in case of a certain minimum purchase amount (for Rs.50 or 100), some other shopkeepers provide such a service to its customers on a regular basis in expectation of a much greater business in future.

It may not be feasible for any Retail store to provide such free home delivery service to all of its customers (due to its large customer base), however some organized retailers have started providing such facility free of cost for a minimum purchase amount (Rs. 1000 or so). We believe that in case the organized retailers manage to provide such free home delivery facility to all of its customers (or at least to customers with minimum purchase of Rs.500), the Kirana stores will be severally affected, as its unique selling proposition (USP) will be under threat from the organized retail stores. Thus, we believe that it is

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quite essential for any Kirana store to provide such a facility of free home delivery to its customers.

Reasonable Quality Standards: Unlike organized retailers, the Kirana storekeepers do not have any quality measures. Moreover the Kirana stores do face the problem of food adulteration, especially in groceries etc., which may have an adverse impact on the Kirana stores goodwill. We believe that quality maintenance can be one of the critical factors for the success for any kirana storekeeper. Moreover up-gradation of kirana shops and providing a clean ambience will further aid the kirana shop-owner to attract and retain customers.



The Road ahead...

Co-existence of organized retail store and Kirana Store

The organized retailers certainly have an edge over the Kirana Stores, primarily in terms of large variety product offering and low cost goods due to their scale of operations. However it may not be such an easy task for any organized retailer to match the personalized services as provided by the Kirana stores.

We believe that it may not be feasible for the Indian consumer to go to a Retail mall for his daily requirements, which can provide opportunity for the local Kirana stores to cater to the day-to-day requirements of the Indian consumers. Moreover, the Retail malls not only offer a shopping experience, but also a complete family entertainment solution (shopping, food and entertainment) to the Indian customers. We expect that the organized retailers may cater to large requirements of the Indian customers, primarily in the form of weekend/monthly shopping, while at the same time, the Kirana stores may cater to the locality specific day-to-day requirements of the customers.

Conventional Kirana stores may face the brunt

We believe that only those Kirana stores, which can provide customize their services as per the requirements of the customers will be able to survive the mounting competition in the Indian Retail sector in the coming years. However, the conventional Kirana stores, which do not provide any value-added services to its customers and thus do not hold any significant advantage over the organized retail stores may have to face the brunt of the massive expansion plans (especially in value retailing business segment) of the retail majors like Reliance, Bharti-Wal Mart and A.V.Birla etc in the coming years.

If you can't beat them...join them!!

At present there are only a few players in the organized domestic retail sector, but with the entry of big players like Reliance, Bharti-Wal Mart and A.V.Birla group, it is quite certain that the new entrants and the existing players will exchange blows in the coming years. Although the existing retail players like Pantaloon will definitely have an edge over the new entrants, we believe that the massive upcoming investments (especially by the new entrants) together with a sound execution will aid the new players to gain a significant market share in the coming years.

Apart from the existing business model of retailing (selling goods through retail stores), we believe even big players like Reliance, Bharti-Wal Mart etc may also enter into an agreement with the local Kirana stores to supply goods to such Kirana stores from their networks – the underlying assumption being that the Kirana stores do get a bargain (primarily in terms of lower cost of goods) from the organized retailers.

Such an initiative will not only aid the Retail companies to increase their market coverage (by penetrating deep into the retail market), but will also guard the Kirana stores from any threat to their existence (due to organized retailers) and can create a win-win situation for both the organized retailers and the Kirana stores.



An initiative from the organized retailers may change the dynamics of the domestic retail industry

As per our analysis, the primary differentiating factor between organized retailers and Kirana stores is the customized service and the free home delivery service of the later. It may be an uphill task for the organized retailers to customize their service, since unlike Kirana stores, the organized retailers cater to a large customer-base. However, we believe that an initiative from the organized retailers to provide free home delivery service to its customers may change the entire dynamics of the domestic retail sector.

Such an initiative from the organized retailers will not only solve the primary concern of any retailer – to attract the unorganized retail customer, but will also help the organized retailer to increase its market presence in the domestic retail sector. At present, there are some organized retail players who do provide a free home delivery service on a minimum purchase size, (starting from a minimum of Rs 1000). We believe that if this minimum purchase amount is lowered to around Rs.500, there will be a tremendous rise in the customer traffic.

However there are some preconditions like an efficient logistics system and backend management, which need to be duly fulfilled, so as to make this initiative a success. At present, Pantaloon is the only retailer to have substantial presence in both value retailing (food and groceries) and lifestyle retailing (apparels, footwear etc), which has outsourced its logistics to another company. However with the entry of Bharti-Wal Mart and Reliance, we believe there is significant investment in the pipeline, which can provide such big players to capitalize on such an initiative.



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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