Indian Consumer

Tastes of India

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India
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Tastes of India (ToI) series is an attempt to provide investors an insight into the Indian Consumption story. We would aim to capture different facets of consumption in our coming

these insights will translate into profitable investment opportunity.

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Distribution: 'Push' is necessary for 'pull'

India's 1.2bn population while indicates the huge consumption opportunity, the tally of 8k towns and 640k villages highlights the challenge. Any FMCG marketers' lofty plans to launch new brands, supplemented by an advertising '<u>pull</u>' may get challenged in the absence of a distribution '<u>push</u>'. Almost all the marketers have been focusing on distribution expansion, therefore, which has also helped in growth acceleration in rural India. The modern trade channel has been gaining traction but contributes a moderate ~6% to sector revenues and unlikely that its proportion would rise much beyond 20% in the coming decade, implying distribution complexities are here to stay in India.

India is a complex consumer market

- While India's 1.2bn population signifies the consumption opportunity in India, its size and diversity poses a challenge for the FMCG marketers.
- With 70% of population in rural India, the segment becomes quite relevant but lack of infra, fragmentation, low per capita income makes it complex on two fronts…
- … a) <u>distribution</u>, as the large number of rural residents is spread across many small purchasing centers; b) <u>product</u>, given lower income levels, consumers tend to be more value-conscious and often buy in smaller quantities, but more frequently.

Distribution is a key challenge, particularly in rural India

- India has ~7.5m traditional (Kirana) outlets, of which 65%+ are in rural India.
- Given the lack of infrastructure, scattered stores with lower through-puts, FMCG marketers employ 4-5 layered network in order to reach the target consumer.
- Rural distribution has been a thrust for the marketers in the last few years and companies have been working on several projects to expand the reach.
- For example, HUL trebled its rural reach in 2010; Emami too has been working on a project to reach all >5,000 population towns by 2013.
- Interestingly, urban markets too pose problems as the periodicity of servicing in case of kirana stores is quite high as kirana channels can carry only a limited stock.

Modern trade has been gaining traction…

- The journey of modern trade started a decade back in India. It was once considered a serious threat to kiranas, but contributes only 6% of FMCG sales today.
- While its contribution to overall sales is relatively low, the contribution in large cities is much higher at 20-40%, which indicates the success of the format.
- In this context, it is also useful to note that the proportion of modern trade is much higher at 30-60% in segments like footwear, apparel etc.

… but kirana stores too have changed for good

- Interestingly, our channel checks and media articles indicate that modern format has not impacted kirana meaningfully…
- … owing to factors like home delivery for even small purchases, credit to consumer (monthly account), increased focus on being contemporary etc.
- So, while urban consumers may look at the local hypermarket for monthly supplies, the mid week top ups and quick purchases are all done at the nearest kirana.
- As a result, while modern trade format has been growing at 25%+, traditional format too is growing at 15-20%, despite its high base.
- Industry estimates that the share of modern trade would still remain 18% of FMCG sales in 2015 and 25% in 2025.

Few interesting facts on India retail

- A typical 100sqft kirana store reportedly operates with ~22% gross margins with Ebitda margin of 7% as there is no opportunity cost of capital as well as labor.
- In order to compete with Kirana stores in Mumbai, certain modern outlets have started offering home delivery, along with discount coupons etc.
- Importance of 'micro focus' is evident from the fact that India's second largest detergent brand is homegrown north Indian firm, '*Ghari*' (revenues: > Rs20bn; 13%+ market shares).

Size and diversity of India makes it a complex market…

Making the most of India's large demand will require FMCG companies to cast a wide distribution network

While India's top-20 urban cities are major consumption centres, there is substantial demand beyond these areas. Reaching those consumers remains a challenge, with traditional distribution platforms requiring substantial time to build out a direct business-to-consumer (B2C) network. A few key statistics about the Indian population showcase the challenges of B2C distribution:

- Only 20% of people live in cities with populations of 100,000 or more.
- India has more than 45 cities with population of one million or more and more than 200 cities with population of 200,000 or more
- According to McKinsey Global Institute, 30% of India's population is urbanised.

We expect the number of cities with more than 1m people to increase to 75 from the current 47

Figure 1

Urban centres

Population	No. of urban centres
<1 million	5,000+
>1 million	47
>2 million	16
>5 million	8
>15 million	3
Total population in cities with over 1 million people (m)	**152**

Source: World Gazetteer, MGI, TSMG

… and rural India is a very important market

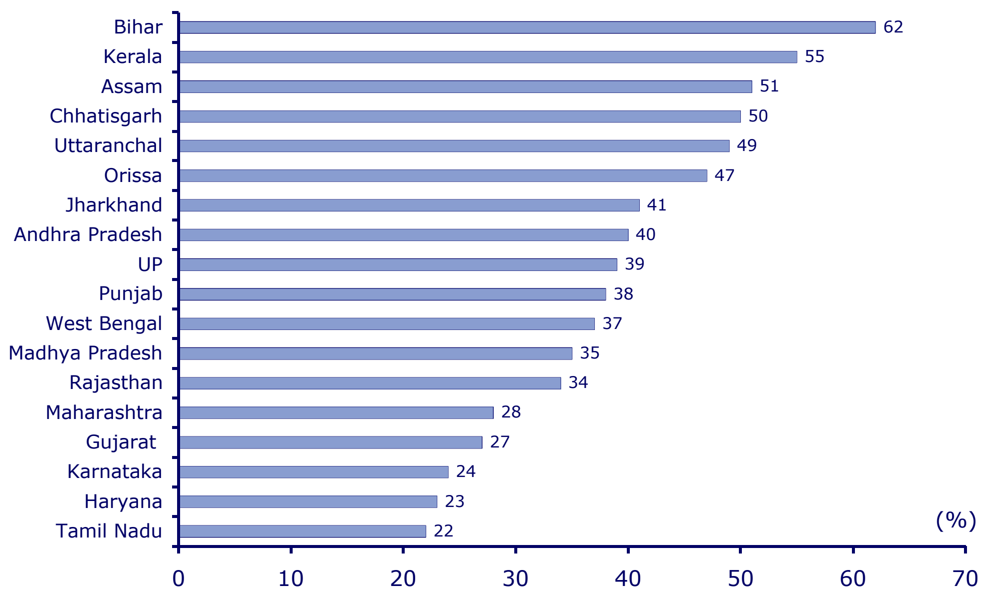
Rural India forms 70% of population base and 55% of consumption expenditure

According to the Indian census' definition of urban aggregation - population of more than 5,000 people; density of more than 400 persons/km²; and 75% of male workers in non-agricultural sectors - only 30% of the nation's population is urbanised. The remaining 70% (more than 800m people) lives in scattered, small villages. While seemingly irrelevant, given lower levels of per-capita income, rural India contributes 55% of consumption expenditure. This makes it a very important end-market for consumer goods.

Rural India constitute 20-60% to FMCG sales across different states in India

Figure 2

Contribution of rural India to FMCG sales in states



Source: FICCI-Nielsen report on rural India, CLSA Asia-Pacific Markets

Unique and complex last-mile distribution in India

Rural India offers two challenges - distribution and the pricing point

In tapping the rural consumer, the key challenges that companies face are twofold. The primary one is distribution, as the large number of rural residents is spread across many small purchasing centres. The second issue has been product. Given lower per-capita income levels and media exposure, and their patterns to spend on necessities, rural consumers tend to be more value-conscious and often buy in smaller quantities but more frequently.

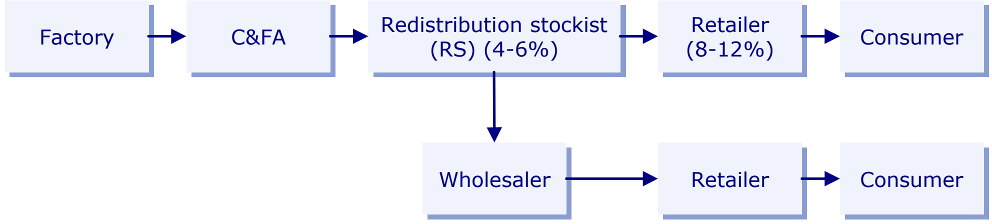
This poses unique challenges for last-mile distribution in India

On distribution, even if a company were to target only locations with 200,000 or more people, it would need distribution coverage in more than 200 cities. The firms therefore use a 4-5 layered network to reach the ultimate consumer. Setting up distributor, dealer and retailer relationships across so many locations ends up being a major entry barrier in the segment. Some of the oldest consumer companies in India, such as HUL, Colgate and Marico, reach 3.3-6.3m retail outlets. Of its 6.3m retail outlets, HUL reaches 1.5m directly and the rest through the wholesale channel.

Multi layered distribution chain in India

Figure 3

Typical channel for consumer firms (numbers in bracket is margin for the trader)



Source: Industry; CLSA Asia-Pacific Markets

Even the retail formats vary in India

Distribution network has to cater to a variety of retail formats

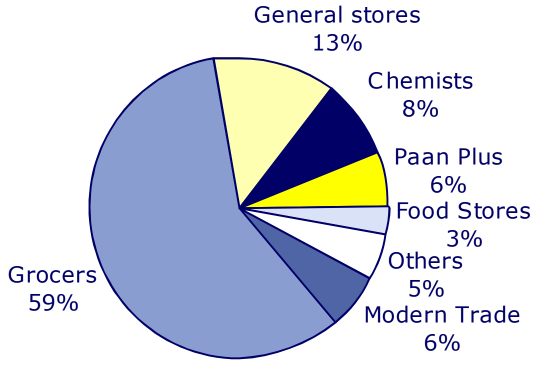
Additionally, there are number of retail formats like grocers, general stores, chemists, paan shops etc. which form part of traditional channel. The average through-put in these units is quite low given their size and the addressable market but in aggregate, they form ~94% of overall FMCG sales.

The journey of modern trade started in India around a decade back, a channel which has been consistently growing ahead of general trade. Interestingly, while the evolution of this channel was seen as a big concern for traditional channel, at an aggregate level, there has been a limited impact and the format currently is just 6% of FMCG sales.

'Kiraana's and general stores form the thrust of FMCG's distribution network

Figure 4

Spilt of FMCG sales through various channels



Source: Industry sources

FMCG firms have been focussing on distribution expansion

HUL's products reach 84% of the 7.5m stores selling FMCG products in India

India's retail sector is fragmented with about 14m small medium sized outlets of which 7.5m outlets carry FMCG products. Approximately 2.5m outlets are spread over 5,500 towns and cities, with an additional 5m outlets spread over 638,000 villages.

In case of rural India, the companies have to resort to number of distribution layers and modes of transport also reflect this

Figure 5

Last mile connectivity – a complex task

Source: Media; CLSA Asia-Pacific Markets

HUL reaches as much as 6.3m outlets in India with a direct reach of 1.5m outlets which is commendable

HUL's with its mammoth distribution network is clearly much ahead of the peers covering nearly 6.3m outlets and reaches as much as 1.5m outlets directly where it works closely with the distribution channel participants. The company has also been working to expand its rural reach and has in fact, tripled its rural reach in 2010.

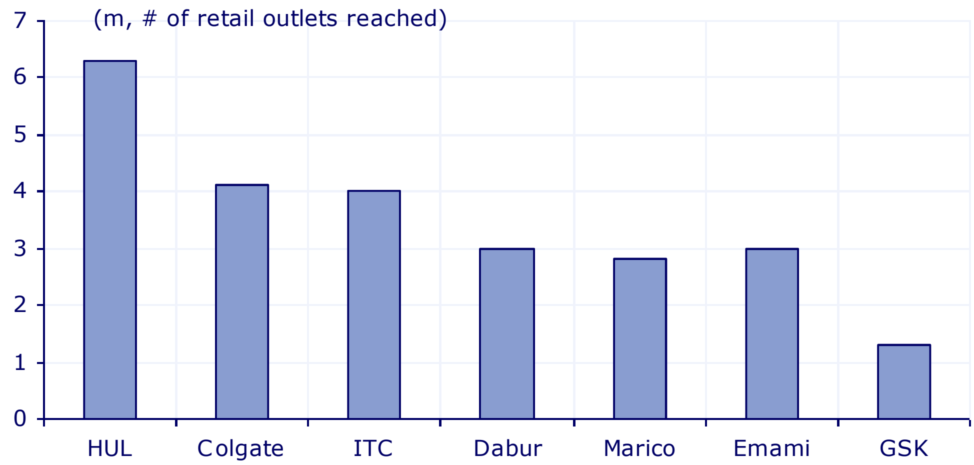
Smaller firms too have been focussing on expanding reach

Distribution expansion has also been a focus for almost all the firms in the sector and the companies have been working on to increase the reach. For example, Emami has been working on project '*Swadesh*' through which, it aims to reach all 5,000 population towns by 2013. In fact, the distribution expansion is one key reason for the higher growth rates in the rural India, for several FMCG firms in the last several quarters.

HUL has clear advantage over peers in its reach

Figure 6

Distribution reach for key FMCG firms



Source: CLSA Asia-Pacific Markets

Organised retail is still in early stages of development in India

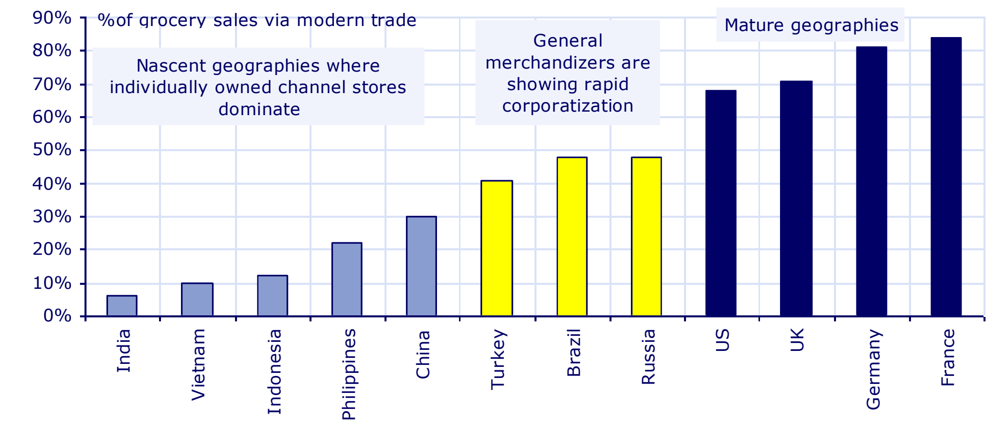
While overall modern trade proportion is small...

Organised retail is still in a nascent stage in India, contributing to ~6% of overall retail sales. India currently has over 14m retail outlets across all categories and reaching even half of those is a challenge. While its share is already more than 30% of sales in segments like footwear, apparel etc., in case of FMCG it is still at just 6% as highlighted earlier

India shows the lowest presence of modern trade in grocery sales

Figure 7

Modern trade as a proportion of overall grocery sales



Source: CLSA Asia-Pacific Markets , Bain

The proportion of modern trade is as high as 20-40% in top urban centres

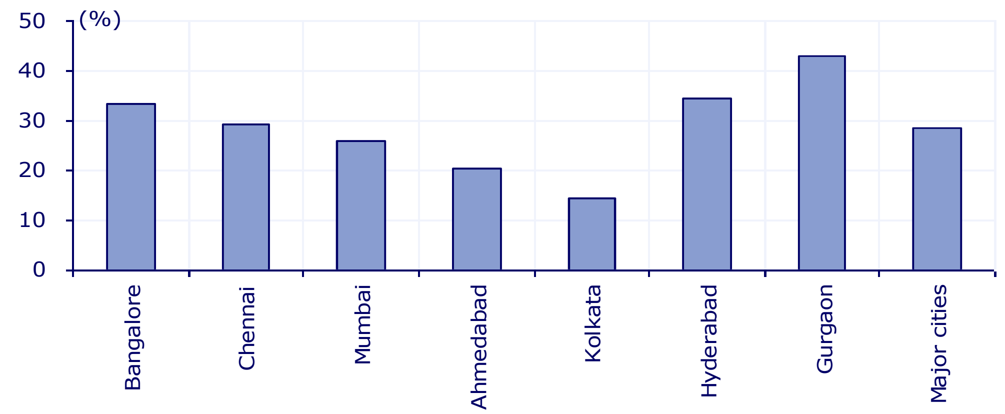
... it is quite significant in top urban centres...

Even in the underpenetrated staples segment, organised retail is gradually gaining importance. While its contribution to overall sales for a diversified FMCG company like HUL is relatively low (about 9-10%), the contribution in large cities can be as high as 40%. Our channel checks indicate that in a bid to lure consumers and in order to compete with Kirana stores in urban India, modern trade outlets have also started offering home delivery for larger ticket purchases along with discount coupons etc. which too has also been helping.

Channel checks indicate that in order to compete with Kirana in urban India, modern trade outlets also offer home delivery for larger ticket purchases

Figure 8

Proportion of modern trade in key urban centres for Hindustan Unilever



Source: HUL

… though, Kirana stores are here to stay even in urban India

Both formats doing well

However, while urban consumers may look at the local hypermarket for monthly supplies, the mid week top ups and quick purchases are all done at the nearest kirana.

Kirana offers too much convenience

Interestingly, our channel checks indicate that kirana stores remain popular due to the convenience factor. So unlike modern stores, a kirana store is ready to deliver of even a small packet at home. And interestingly, credit is one another important reason why Kirana stores are so popular in urban India where, a consumer has a running account with the nearby kirana store which is settled on a monthly basis.

Figure 9

Majority of kirana stores are inherited …

73% of all mom-and-pop stores are owned, not leased, and 62% of all stores are inherited from parents/family

Figure 10

… and operate with lean margins

As per estimates, a typical 100sqft kirana operates with 22-23% gross margins with EBITDA margins of 7% (15% of sales is spent as labour costs, whereas other overheads are negligible small)

Source: Media

Figure 11

National brands have lower trade margins …

"Imported food items offer the highest margin, about 20%. Local brands give us 15-20% while multinational companies like Unilever and Nestlé offer 10-15% margin"

Figure 12

… and credit is hard to come by

"Credit has become history. Earlier companies offered 15 21 days window to pay for the inventory. Now they want payment on the spot or within seven days. Several multi nationals do not encourage sale on credit at all"

Source: Media

Figure 13

Higher sales with better floor design

Lower cost of capital allow kiraana stores to work with lower inventory turnover. As per estimates, 70% redesigned kiranas register 15-20% higher sales in just six months

Figure 14

Supermarkets are more profitable than kirana

A typical supermarket can accommodate 20-22 kiranas. But they make profit equivalent to 27-28 of them

Source: Media

Modern trade would form a moderate proportion of FMCG sales

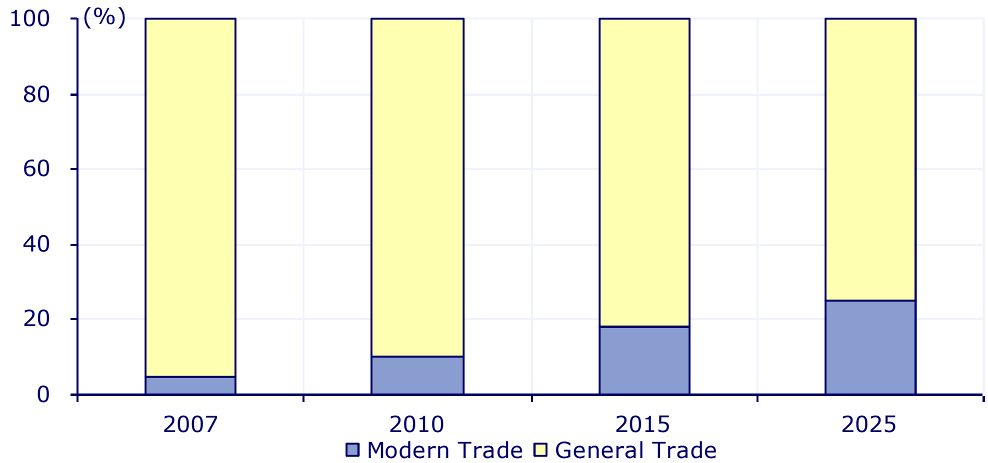
Ticket size would go down as modern trade gets into smaller towns

While modern trade has become a decent proportion of FMCG revenues as highlighted earlier, this has also been possible due to high population density in these centers. However, as the modern trade starts to penetrate into smaller towns and villages, the challenge would rise and incremental sales would be lower than current average, in our view.

While the modern format will continue to grow ahead of traditional, unlikely that its proportion would rise beyond 20% even in the next decade

Figure 15

Distribution channel mix – modern vs. general trade



Source: HUL

Rural is all about being 'micro'

Ghari brand is one of the greatest successes, thanks to its micro focus

Ghari detergent is India's second largest home & personal care brand by volume, and, its dominance in the region of its origin, ie, Uttar Pradesh is undisputed. An aggressive pan-India distribution push, coupled with a bold pricing game plan, have helped Ghari, founded in 1987, cross the Rs20bn mark in sales at the end of FY11. The tipping point of this growth came in the last three years when Ghari expanded from its home turf in Uttar Pradesh to 19 states. The company is a believer in BTL (below-the-line) marketing through exhibitions, melas and road shows in rural India. Resultantly, Ghari spends under 2% of its sales on A&P cf. 10-15% for the FMCG giants.

Higher margins are instead diverted to the channel participants

The margins are instead diverted to their distribution network by sharing greater margins with wholesalers and dealers. This gives Ghari that much needed push at the point of sales. To complete this push effect, the company added over 1,000 dealers and now has a total network of 3,500.

Focussed advertising highlighting superior product quality to target consumers

Figure 16

Ghadi detergent powder

Figure 17

Ghadi's soap bar

Source: CLSA Asia-Pacific Markets

Efficient inventory management is critical to enhance return. on investments…

Strategies adopted by companies to drive sales, profitably

Smooth and seamless flow of information between factories, C&F agents, dealers, distributors and wholesalers is critical for efficient inventory management. In the last decade, FMCG majors began implementing some form of an ERP system which in the past linked the larger warehouses, at best. But now the penetrations of ERP systems have reached ground level with salesmen booking orders on their palmtops.

… for both FMCG firms as well as dealers

With developments in SCM, ERP and implementation of JIT, firms are leaner and making it possible to raise substantial cash via inventories. FMCG firms maintain a negative working capital cycle by giving zero days of credit to their dealers and paying their suppliers end of the month. Also, the IT tools also enable the firms to keep distributor inventory levels helping in higher return on investments.

Incentivising their distributors is another are that FMCG marketers focus on

Incentivising their distributors is another are that FMCG marketers focus on to deliver consistent growth and maintain or enhance market shares. Often there are freebies for bulk orders. But to engage their distributors more proactively, most FCMG firms come up with regular interesting schemes. Distributors who have generated certain volumes are eligible for win points based on their sales which entitles them to various prizes (see below).

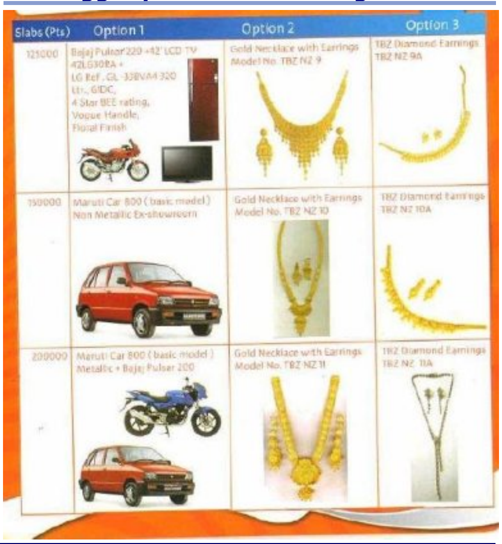
An Indian FMCG major uses an interesting gift system to incentivise its dealers and distributors

Figure 18

Home appliances for smaller dealers

Figure 19

And bigger prizes to drive larger dealers



Source: Industry

E-choupal has provided strong support to ITC's FMCG initiative

Interesting distribution channel #1: ITC's path-breaking E-choupal

ITC was one of the first companies to recognise rural potential when it set up its unique e-choupal initiative in 2000. An e-choupal is a low-cost IT-enabled rural hub to establish relationships with farmers. Each e-choupal generally covers five or six villages and is managed by a local (called the *sanchalak* or organiser) who earns a commission on the transactions at the hub, turning this individual into an active entrepreneur.

The IT backbone is simple and is equipped with solar-powered cells and a VSAT internet connection. This enables the hub to function smoothly and at low cost, even in far-flung villages that lack telecom and power facilities.

ITC procures commodities as well as distributes products through E-choupal network

Figure 20

E-choupal snapshot

Indian states covered	10
Commodities	Soya, wheat, coffee and marine products
Villages	40,000
Choupals installed	6,500
Farmers serviced	4m
Rural distribution	
Partners	100 companies
Product range	FMCG, consumer durables, agri-inputs etc.
Financial services	Insurance, credit (Kisan credit cards)
Rural retail	
Choupal sagars	24

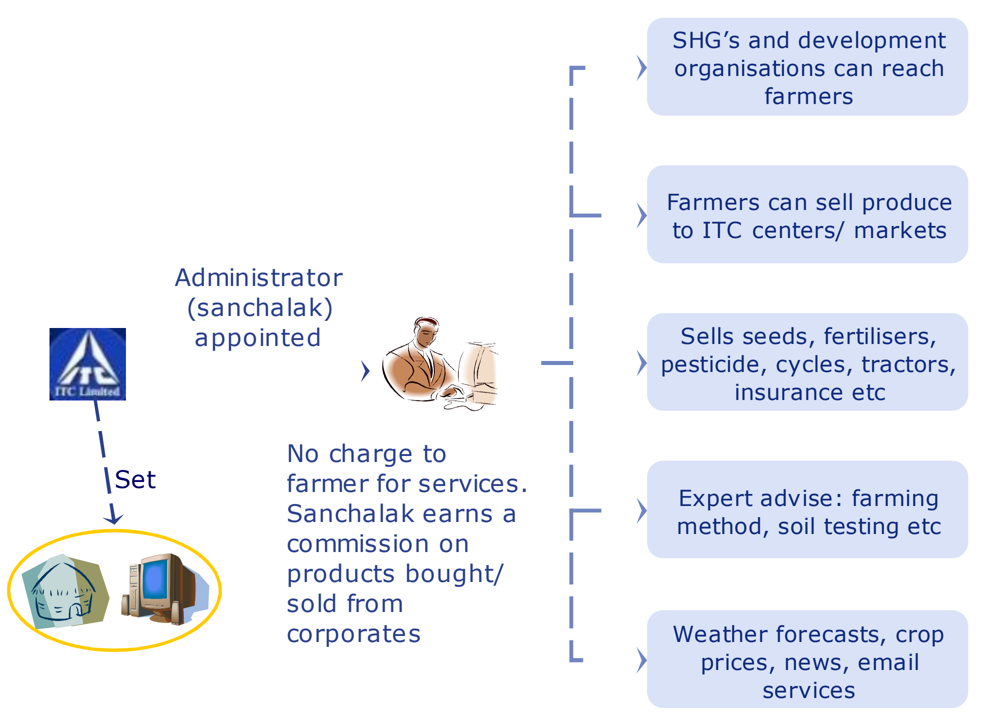
Source: CLSA Asia-Pacific Markets

ITC's e-choupal services today reach out to more than 3.1m farmers, growing crops ranging from soybean, coffee, wheat, rice, pulses & shrimp- in over 31,000 villages through 5,050 kiosks across 6 Indian states.

Multiple services provided by ITC to the farmers

Figure10

ITC's *E-choupal* initiative



Source: CLSA Asia-Pacific Markets, FAO, India Today

Interesting distribution channel #2: Paints sector

Paints is one of the most complex logistics business in India

Paints is one of the most complex logistics business in India and unlike a typical FMCG distribution, there are no middlemen here. This implies that companies have to directly reach out to the small hardware shops which stock paints along with several other things.

Asian Paints reaches as many as 27,000+ retail outlets today which is more than 2.5x of the next competitor

In a working capital heavy industry Asian Paints has been able to provide retail buyers the maximum variety while keeping its working capital low through a distribution system which has been an early adopter of the newest technologies. And it reaches as many as 27,000+ retail outlets today which is more than 2.5x of the next competitor.

Signature store of Asian Paints as well as a typical hardware store

Figure 21

A Colour world store

Figure 22

Dealers for Asian Paints

Source: CLSA Asia-Pacific Markets , Media

Asian Paints' state of the art IT system allows them to capture and cater for such a local and specific demand spike as well

IT systems form the core of this innovation. All the company's paints plants in India (i.e. 2 chemical plants, 18 processing centres, 350 raw material and intermediate goods suppliers, 140 packing material vendors, 6 regional distribution centres and 72 depots) are integrated. Information moves seamlessly from dealers to central stockists to manufacturing units allowing for more accurate demand forecasting for each SKU.

Their "Colour World" outlets targeted at retail consumers aim to simplify the process of home painting and encourage buyers to try more unconventional shades. The recent campaign hopes to increase the frequency of repurchase in the long term.

Interesting distribution channel #3: HUL's Project Shakti

HUL derives almost half of its revenues from rural areas

HUL derives almost half of its revenues from rural areas. In order to increase its product penetration in rural areas, management has taken several innovative steps. HUL has a unique programme – Project Shakti – which helps to deepen the company's rural distribution reach. Through Project Shakti (meaning strength or empowerment) HUL aims to build a low-cost distribution network in small villages.

Under the programme, rural women are recruited and enrolled as entrepreneurs

Under the programme, rural women are recruited and enrolled as entrepreneurs. They are then coached in the basics of brand communication, product selling and consumer behaviour. These local brand endorsers then sell the products on to their fellow villagers in a twin format – either by having a central kiosk or by home-to-home selling.

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Figure 23

Training session for Project Shakti

Figure 24

A Project Shakit agent in Khurrampur

Source: CLSA Asia-Pacific Markets, HUL

HUL has over 45,000 *'Shakti Ammas'* who reach 3m homes and 135,000 villages

As per estimates, on an average, a Project Shakti agent records monthly sales of Rs10,000, on which she earns Rs600-800. Her earnings come out of a 3% discount that HUL gives her on its products, as well as a trade margin of approximately 10%. HUL has over 45,000 *'Shakti Ammas'* who reach 3m homes and 135,000 villages.

Interesting distribution channel #4: Alcohol

Only 65,000 such licensed outlets exist across the country

United Spirits and United Breweries enjoy huge advantage

As per India's complex tax laws, the state government has the right to tax production and sale of spirits/ beer in a state. Additionally, to open a liquor store, store owners require a state government sanctioned license. Only 65,000 such licensed outlets exist across the country. The complex laws in India necessitate creation of production capacities at almost all the sates which is a cumbersome task and the two leaders in the respective segments, United Spirits as well as United Breweries have created a strong network and model that is difficult to replicate.

Maharashtra state issued beer only licenses

Interestingly, the Maharashtra state government issued 1500 new 'beer and wine only' licenses in the last few quarters. These new licenses have allowed modern trade as well as local shops to stock wine and beer as well. There has been a pick up seen in industry volumes in the state after the issuance of these licenses. Similar favourable steps by other states could provide a boost to the beer volume growth in the next few years.

Figure 25

Typical liquor shop in Mumbai

Figure 26

Wine counter inside a Godrej Nature's basket outlet

IKEA isn't and FMCG company, but raises an interesting question on whether a similar model can succeed in India?

IKEA is an example of creating a "pro-sumer' half producers and half consumers.

Interesting format : Ikea – can we see something like this in India?

IKEA is a great example of passing on the burden of distribution to your customer. IKEA provides ready-to-assemble furniture, with detailed instruction manuals to its customers. All of its 128 stores spread across 26 countries are fully owned by IKEA. Fixed costs and overheads for its retail operation are kept at a minimum by maintaining warehouse-like stores with a lean staff.

In stead of staffing its stores with sales assistants, IKEA stores greet all their customers with a small kit containing a notepad, pencil, catalogue and measuring tape. Consumers then browse through the warehouse-like store with little assistance. Staff are, instead, directed towards a crèche and an in-house café, making sure, shoppers can spend more time at the store, making more purchases.

Figure 27

Stores resemble large warehouses

Figure 28

IKEA's global footprint continues to grow into Asia

Source: CLSA Asia-Pacific Markets

With manufacturing outsourced, the company can now focus singularly on design

While innovative product design is a given, IKEA also places a lot of importance on designing the most efficient packaging for its products.

Price matrix is quite simple, with 3 basic price ranges (high, medium and low) spread across four basic styles (Scandinavian (sleek wood), modern (minimalist), country (neo-traditional), and young Swede (bare bones)). Where most consumer durable companies start product design from a concept or functionality, IKEA's product design starts at pricing.

Probably one of the most important inventions of IKEA were the flat boxes to transport the furniture easily. This reduces IKEA's transport costs from manufacturers to stores, but also their customers transport costs. There are around 18 IKEA distribution centres globally, situated near container ports, 70% of sales move from manufacturing to stores through IKEA's distribution centres. The remaining 30% moves directly from manufacturers to stores, and IKEA of course hopes to be able to increase this share.

Key to CLSA investment rankings: BUY = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).