Indian Single Brand Retail – Poised for growth

September 2013



Building a better working world

RETAILERS ASSOCIATION OF INDIA

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Abbreviations

PPP	Purchasing power parity
GDP	Gross domestic product
CAGR	Compounded annual growth rate
FDI	Foreign direct investment
BRIC	Brazil, Russia, India and China
EBOs	Exclusive brand outlets
MBOs	Multi-brand outlets
CDIT	Consumer durables and information technology products
GoI	Government of India
SBRT	Single-brand retail trading
MBRT	Multi-brand retail trading
DTC	Direct tax code

Foreword

Dear Reader,

In the last few years, single brand retailing has emerged as a big opportunity in India. Not only have many international brands entered India but several have also been quite successful after some initial period of learning. The opportunity has evolved over time due to various factors beyond just that of growth in consumption. Preference for modern retail, a rising working women population, a desire for better quality and international brands are all driving growth in single brand retail. The recent liberalization of the retail FDI norms, the success of some recent entrants and the quest for overseas brands to expand into high growth markets will be some of the key growth drivers in the future. We believe that this is perhaps the best time to enter India.

We are delighted to present our report, Indian Single Brand Retail – Poised for growth, in association with the Retailers Association of India (RAI). This report aims to provide a broad overview of India's Foreign Direct Investment (FDI) policy for single-brand retailing and the associated market opportunity for foreign brands/ retailers across relevant categories.

Pinakiranjan Mishra
Partner and National Leader
Retail & Consumer Products
EY India

Dear Reader,

India is definitely a market that allures many retailers. It is a market that is neither easy to conquer not easy to ignore. The market has a huge potential but the sheer diversity of consumers and the legal environment is daunting to some global retailers. Retailers Association of India & EY have created the paper to demystify some key aspects around FDI in retail in India. Our belief is that this would get some of the procedural aspects in context. India can be a lucrative market for investors with long term vision and ability to adapt to diverse consumer segments.

Kumar Rajagopalan
CEO
Retailers Association of India

Executive summary

India's consumer market has experienced unprecedented growth in the last decade. This trend is expected to continue, and India would likely to emerge as one of the fastest-growing economies[1] in the world. A favorable demographic profile and rising income levels would be the key drivers of this inclusive growth. As a result, the US$500-billion Indian retail market is expected to grow at a CAGR of 12% to reach a value of US$900 billion by 2017. The relevant organized market, which is currently valued at US$35 billion, is expected to grow at a CAGR of 21%, to reach a size of US$90 billion by 2017.

The Indian organized retail market is in the growth phase, and the associated stakeholders – retailers, consumers, vendors, mall operators and regulatory bodies – are evolving simultaneously.

The recent liberalization of the FDI retail policy has come as a major boon to foreign retailers that are looking to set up/expand operations in the country. Single-brand retailing is primarily driven by categories such as apparel and accessories, footwear, which account for more than one-third share of the organized retail market (US$35 billion in 2012). This liberalization would further drive the shift toward organized retail across these categories.

Going forward, a player would be required to conduct a study of the relevant market opportunity and formulate a well-planned entry strategy and implementation plan to grow and sustain in India.

1 Countries considered in the report are BRIC nations, The US and The UK

Chapter

01

India's consumption story

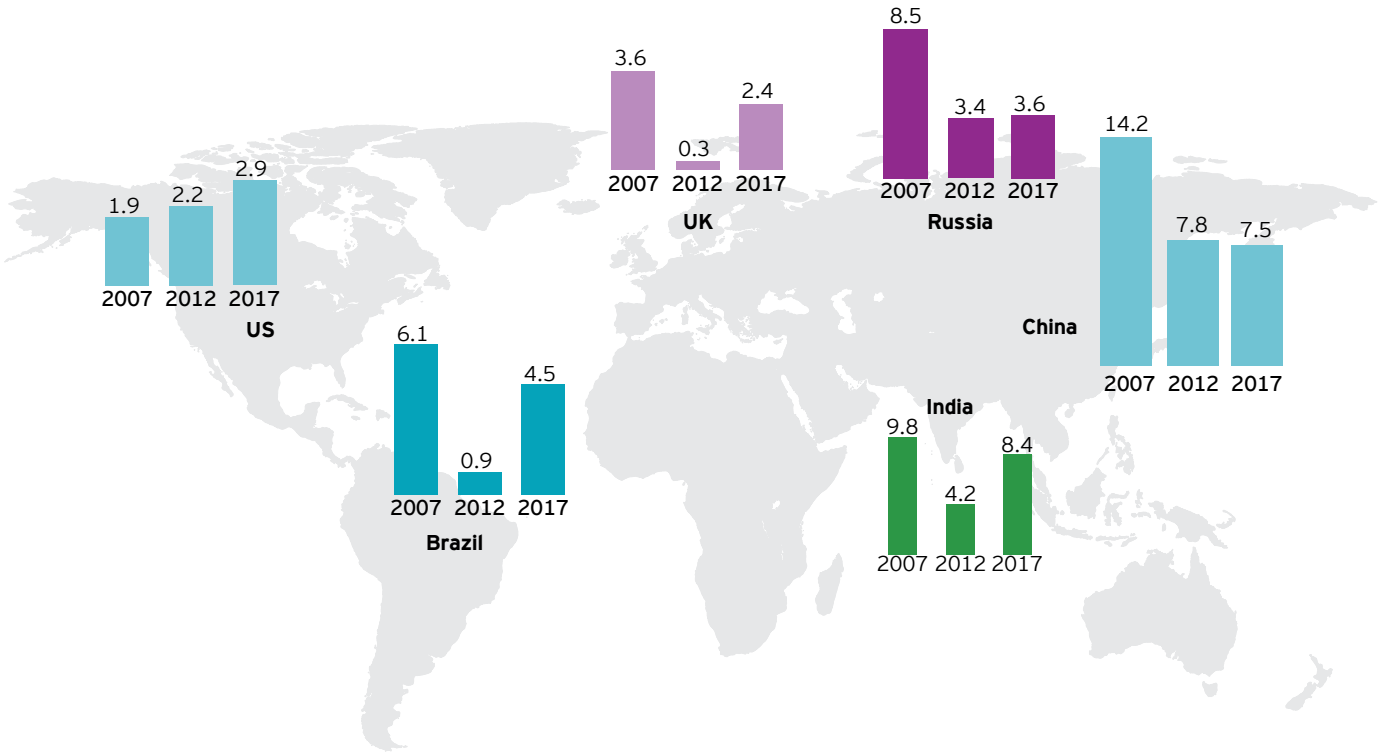
1.1 India is one of the largest economies in the world, and it is expected to grow faster than most peers until 2030

India is among the top 10 economies (by GDP) in the world, and it is poised to become the 3rd largest by 2030. In PPP terms, India came in at third spot in 2012, after the US and China.

Exhibit 1: Forecast Nominal GDP of Nations



Exhibit 2: Yearly real GDP Growth Rates



Source: IHS Global Insights, accessed on 14 August 2013

India has registered a healthy real GDP growth of over 7% p.a. between 2007 and 2012. It is the second-fastest growing economy among the BRIC nations, after China, and it is expected to continue this growth trajectory over the next five years.

Tim Cook said that while he "loves India," the multilayer distribution structure in the country "really adds cost to getting product to market," and as a result, "in the intermediate term there will be larger opportunities outside of there."

"Apple CEO Tim Cook: "I love India, but…"", http://gadgets.ndtv.com/mobiles/news/apple-ceo-tim-cook-i-love-indiabut-247307, accessed on 22 August 2013

Tim Cook
CEO, Apple Inc

Apple Inc CEO Tim Cook has taken a U-turn on his stance on India, saying "iPhone sales in the country beat all expectations to soar 400% in the April-June quarter just a year after he famously said he loved India but felt business opportunities were much more elsewhere."

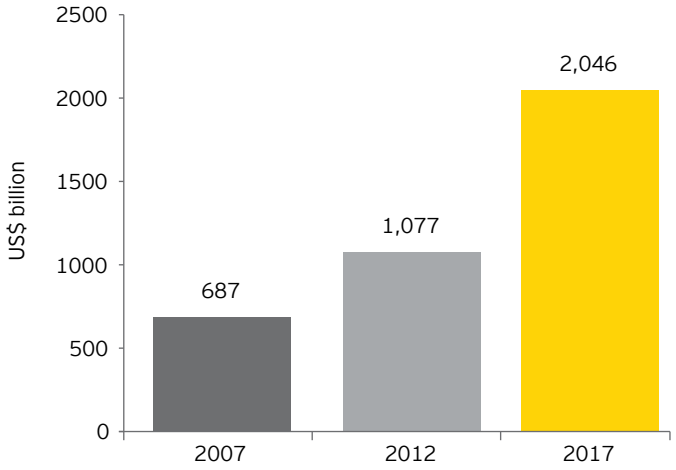
Writankar Mukherjee, "Apple iPhone sales record 400% growth in India, Cook," The Economic Times, 26 July 2013, via Factiva, © 2011 HT Media Ltd.

While the Indian economy witnessed a slowdown in 2012 (GDP of US$1.9 trillion), the domestic consumption story, nevertheless, seems intact and is expected to drive inclusive upward growth until 2017 (to reach a GDP of US$3.7 trillion).

1.2 Private consumption expenditure forms a major share of GDP and is expected to register a healthy nominal growth of CAGR 14% between 2012 and 2017

Increasing consumption expenditure in the country has supported economic growth. By 2025, India is expected to rank among the top 5 economies in terms of consumption, an improvement from its 12th position in 2010.

Exhibit 3: India's nominal private final consumption expenditure in billion US$



Source: IHS Global Insights, accessed on 14 August 2013



1.3 Favorable demographics and rising income levels are the key factors in ensuring sustainable economic growth for the country

The median age of the population in India (~26 years) is the lowest among BRIC nations. The share of the working group aged 15-64 years is expected to increase from 65% (~818 million) in 2012 to 67% (~886 million) by 2017. This large working population will emerge as the key consumer group and would drive the growth of consumption. With the median age expected to touch 31 years in 2025, the Indian population is likely to continue to be among the youngest in the world.

Around 59% of the population is likely to fall in the middle-income group[2] by 2020 as compared to 44% in 2010. The share of the affluent and elite section is also expected to increase to 13% by 2020, up from 6% in 2010. This demographic profile will fuel sustainable growth in India, and the trend is set to continue.

However, the Indian market is facing a double- edge sword of rising inflation and rapidly weakening Rupee. Nevertheless, this seems to be a short-to-medium term phenomena and would most likely not pose as a threat to India's long-term consumption story.

In conclusion, the Indian consumer market offers challenging, but a sizeable potential for global companies.

2 Annual household income of US$3,500 to 20,000



Chapter

02

India's burgeoning organized retail market

"Modern trade contributes "12-15% of our business," Paranjpe said in the interview, adding, "In another five years, maybe it will be 25% of our business."

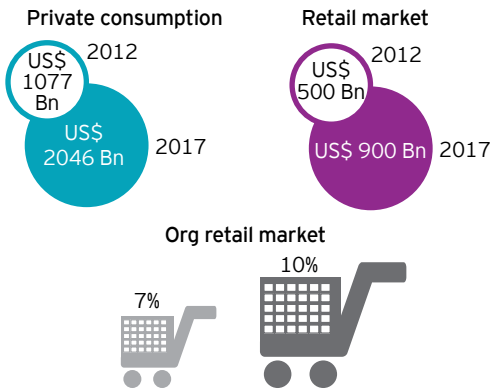
"HUL to focus on beauty, food, modern trade and rural area",http://www.livemint.com/Companies/Ih8eZIo64FXiH2gPDSqYqI/HUL-tofocus- on-beauty-food-modern-trade-and-rural-area.html, accessed 22 August 2013

Nitin Paranjpe
Chief Executive & Managing Director,
Hindustan Unilever Ltd (HUL)

2.1 Indian retail sector is thriving and is expected to grow at CARG of over 12% until 2016

In 2012, the retail sector was worth US$500 billion and was among the largest employers in the country. The sector is set to grow at a rapid pace, with a gradual shift toward organized retailing formats. By 2017, the Indian retail sector is likely to touch US$900 billion, indicating a CAGR of more than 12%.

Exhibit 4: India's retail market



Source: IHS Global Insights, August 2013 and EY-UKIBC report Road to India's Consumer Market [3]

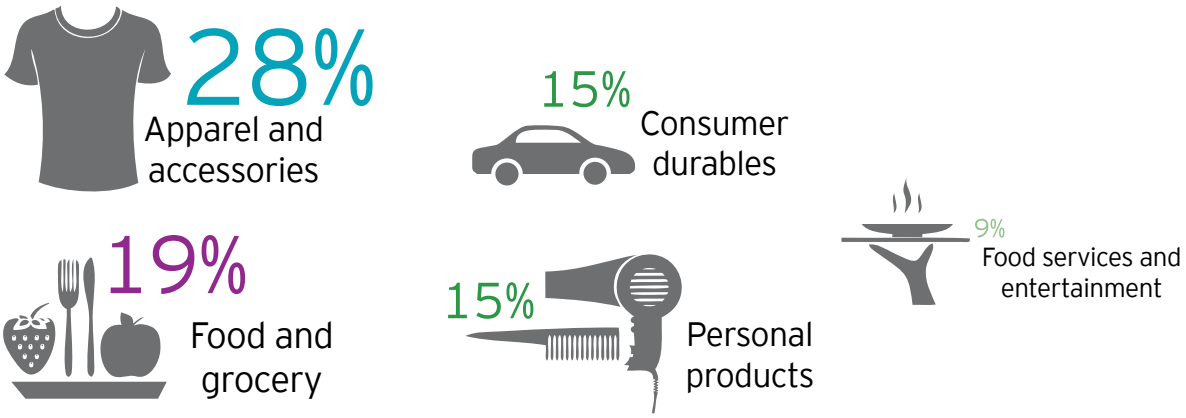
Organized retail penetration is expected to increase from 7% in 2012 to 10% in 2017, signaling a robust CAGR of 21%. This is also borne by the fact that modern retail has become a sizeable part of the most FMCG companies where the penetration of modern retail is low.

3 1 USD = INR 53.4

2.3 Apparel and accessories constitute the majority share of the organized retail market

Apparel retail has a strong organized presence. After the first round of changes in the FDI policy for single-brand retail in 2006, retailers ventured into the market with EBOs across categories such as footwear, personal products, food services and entertainment, thus making this format a popular choice in the Indian organized retail market.

Exhibit 5: Split of organized retail market (2012)



Source: EY-UKIBC report on Road to India's Consumer Market

2.4 Several demand and supply side factors are driving retail growth

Growth in the Indian retail market is driven by a combination of demand, supply and regulatory factors. The three pillars are expected to continue being the growth engines of the Indian consumer and retail market.

Exhibit 6: growth drivers for the Indian retail market

India retail growth value proposition

Demand factors	Supply factors	Regulatory Changes
Increasing urbanization and migration to towns and cities The contribution of urban areas to India's GDP is expected to increase from 60% in 2001 to 70% in 2018	**Rapid real estate and infrastructure development** Mall space supply across metro cities is expected to increase 40%-50% between 2012 and 2017	**Liberalization of FDI policies for retailing** Between 2006 and 2012, the GoI has progressively liberalized the FDI policy for retailing
Rising disposable income and consumption expenditure Consumption spending is expected to increase from US$1077 billion in 2012 to US$2046 billion in 2017	**Easy availability of credit** Number of credit cards was estimated at 18 million in 2012, and it is expected to increase to 28 million in 2014	**Introduction to GST** The GOI has proposed GST and is close to a consensus on this. Once implemented, it will simplify the supply chain and bring down prices to consumers
Growing number of working women and young population India's median age (26 years in 2011) is the lowest among major economies (BRIC, the US, the UK), and it is expected to be 31 years in 2025. Women employment grew at 20% from 2010 (22.8 million) to 2012 (27.3 million).	**Creating a differentiated experience** Leading modern trade stores stock products/brands procured by local importers; some of them directly partner with leading foreign consumer product companies to exclusively retail and distribute their products in the Indian market	**Introduction of Direct Tax Code** DTC is expected to be rolled out by 2014
Changing consumer preferences Increase in foreign travel and exposure to Western lifestyle have resulted in a shift in consumption habits, leading them to uptrade.	**Introduction of innovative formats** Specialty format: e.g., wedding malls Luxury format: high-end malls for retailing luxury goods Transit format: near airports and metro stations	

Source: EY Research; EY-UKIBC report on Road to India's Consumer Market

2.5 The organized sector opportunity comes with it's challenges

The Indian organized retail market is in the growth phase, and retailers, consumers, vendors, mall operators and regulatory bodies are evolving simultaneously. A potential entrant would need to consider the impact of the following challenges while determining its India strategy:

1 Customer
- India is a market of markets
- High price sensitivity and brand consciousness
- Low conversion ratios and ticket sizes

2 Competition
- Leading Indian business houses have entered or plan to enter the sector
- Unorganized players provide personalized services

3 Others
- High rental costs
- Limited availability of prime retail space
- High attrition of store staff

4 Supply chain, Infrastructure and import regulations
- Poor supply chain infrastructure
- High import duties
- High logistics cost (10% to 13% of GDP)

5 Regulatory Environment
- Complicated FDI policy - FDI up to 100% is permitted in single brand retailing, and 51% is permitted in multi-brand retailing operations with conditions (local sourcing, brand ownership, etc.)

Source: EY Research

2.6 Staying invested and aligning strategy to the Indian retailing environment is the mantra of leading retailers

Given the challenges faced by the sector, leading retailers may be required to continuously adapt their strategies to the changing operating environment. Some of the key themes that would need consideration are to:

- Align merchandising mix to a region and its consumers (local preferences)
- Source prime real estate
- Simultaneously venture into metro and non-metro cities in the region
- Move to an India-based sourcing strategy as quickly as possible
- Avoid complicated franchising models
- Build a tax efficient operating structure

Chapter

03

Indian regulatory environment

3.1 Overview of SBRT

A. The Indian Government hopes to turn a new page in India's retail story.

The GoI is progressively undertaking reforms and liberalizing the retail sector to attract foreign investments. It has gradually opened the regulatory environment around retail trading to pave the way for retail innovation and enhance competitiveness of Indian enterprises through access to global designs, technologies and management practices. The opening of the retail industry to global competition is expected to spur a retail rush to India. It has the potential to not only transform the retailing landscape, but also the nation's ailing infrastructure.

B. Single brand vs multi brand

In the Indian context, retail trade has traditionally been categorized into SBRT and MBRT. While both the models facilitate growth in the retail sector, MBRT has typically been tightly regulated, considering the associated economic and political challenges. On the other side, over the years, SBRT regulations have been consistently liberalized. This has provided the necessary impetus to the sector and has made more international brands accessible to Indian consumers at their doorstep.

C. FDI regulations for SBRT [4]

While allowing foreign investment in SBRT, the GoI was aspiring to:

a. Attract investments in production and marketing;

b. Improve the availability of goods for consumers;

c. Encourage increased sourcing of goods from India; and

d. Enhance competitiveness of Indian enterprises through access to global designs, technologies and management practices.

Until recently, FDI to the tune of 100% was permitted under SBRT, with prior government approval being a pre-requisite. However, the regulations have now been liberalized further as follows[5] :

- Up to 49% is permissible under the automatic route (no prior approval of GoI required)
- Beyond 49% is permissible subject to prior GOI approval

4 Consolidated FDI policy (effective from 5 April 2013)
5 Press Note no 6 (2013 series) issued by Department of Industrial Policy & Promotion Ministry of Commerce & Industry, Government of India

The liberalization comes with a set of prescribed conditions to ensure that foreign investors make a genuine contribution to the development of Indian infrastructure and logistics.

Exhibit 8: Overview of India's FDI policy for SBRT

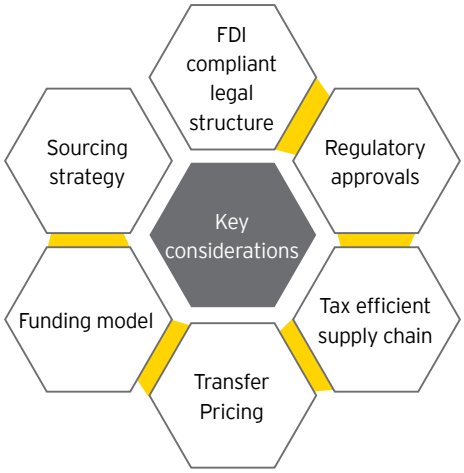
Single brand	Products to be sold should be of a single brand
Same brand internationally	Products should be sold under the same brand internationally, i.e., products should be sold under the same brand in one or more countries other than India
Branding during manufacturing	Products should be branded during manufacturing
Investment by more than one non-resident entity[5]	A non-resident entity or entities, whether owner of the brand or otherwise, is permitted to undertake SBRT, directly or through a legally tenable agreement, with the brand owner The onus for ensuring compliance with this condition shall rest with the Indian entity carrying out SBRT in India
e-commerce prohibited	Retail trading, in any form, by means of e-commerce, would not be permissible, for companies engaged in SBRT in India
Sourcing	In cases where FDI exceeds 51%, sourcing of 30% of the value of goods purchased by the SBRT entity should be done from India, *preferably* from micro, medium and small enterprises, village and cottage industries, artisans and craftsmen, in all sectors It is sufficient to comply with the 30% sourcing condition cumulatively in the first five years of FDI investment Thereafter, sourcing requirement to be complied on an annual basis

Source: EY Research

3.2 Key considerations for foreign retailers/investors

The liberalization in FDI reforms has generated a number of opportunities for foreign investors. By March 2013, the GoI had received and cleared 63[6] proposals of SBRT. With further easing of norms during this month, the number of proposals is expected to increase manifold. Foreign retailers keen on setting up operations in India should consider the following aspects while devising their India entry strategies:

Exhibit 9: Key considerations for foreign retailers/investors from a tax regulatory perspective



Source: EY Research

Overall, the SBRT policy has been attracting global players to the Indian market. However, it is vital for foreign retailers to evaluate their business models and strategies as per the Indian regulatory environment.

6 http://www.dnaindia.com/money/1811716/report-india-clears-63-fdi-proposals-in-single-brand-retail

Chapter

04

SBRT – potential opportunity in Indian retail

4.1 Historically, franchise or licensing was the popular route; going forward, foreign brands are expected to opt for the ownership model

Historically, licensing and master franchising were the most commonly adopted models for entry in India. This was largely due to the evolving FDI regime for single brand retailing in India.

With the evolution of the Indian organized market, the commitment levels of foreign brands/retailers have increased, resulting in higher capital investment in their Indian operations. Some players have set up a subsidiary in India and operate the store network through unit/store-level franchising models, while others establish a joint venture with Indian partners to derive benefit from the policy liberalization.

Recently, the Indian Government has further liberalized FDI regulations in single brand retailing. This has motivated the so-far reluctant foreign brands/retailers to consider entering the Indian market.

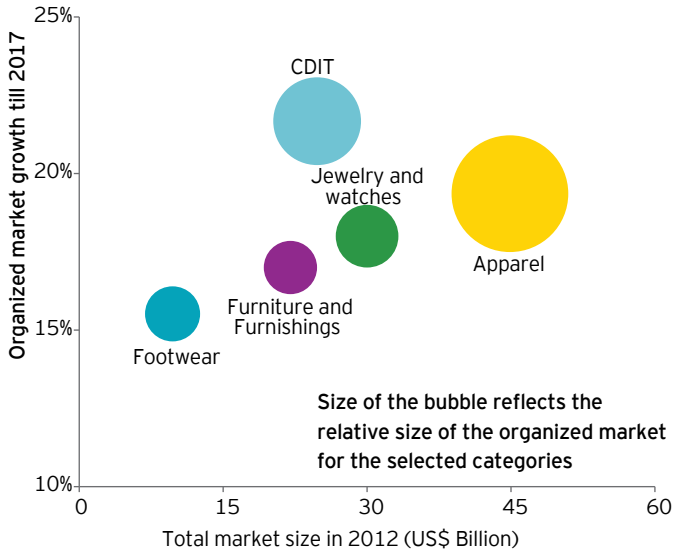
4.2 Foreign retailers across multiple categories can benefit from India's SBRT policy

Single-brand retailing is typically dominated by categories such as luxury goods, apparel and accessories, and footwear. Nevertheless, it also encompasses a host of other product categories.

For categories such as jewelry and watches, personal care, CDIT and travel goods, leading players largely focus on MBOs/department stores to drive sales. However, driven by the width of merchandise and the pull of brand, leading players across categories such as personal care, CDIT, and jewelry and watches are increasingly setting up EBOs.

4.3 There is significant and sizeable growth potential across relevant categories

Exhibit 10: Market size and growth across key categories



Source: EY Research

Low penetration levels in organized retail, coupled with high growth in select categories, are increasingly attracting global players. Although apparel and accessories will remain the mainstay of the Indian organized market and a key category within the SBRT gambit, product lines such as personal products and consumer durables offer significant growth potential.

The liberalization of the FDI policy for SBRT is likely to benefit foreign retailers/brands in categories including apparel and accessories, luxury, footwear, personal care and CDIT.

Chapter

05

Road to India

While the Indian market offers significant potential and it is critical for foreign brands to conduct a detailed opportunity assessment and tailor their business models and strategy as per the Indian environment.

A typical decision road map for entry into single brand retail in India is given below for reference.

Exhibit 11: Illustrative steps for evaluating a foray in the Indian singe brand retailing segment



Appendix – note on FDI policy on MBRT

MBRT is basically the retail trading of products by the same company under different brands. As part of integrating the Indian economy into the world market and for encouraging FDI in India, the GoI has allowed 51% FDI in MBRT, subject to prior approval and certain conditions that are briefly discussed below.

Minimum investment

A minimum of US$100 million is to be invested.

Back-end infrastructure investment

Atleast 50% of the total FDI brought in the first tranche of US$100 million is to be invested in back-end infrastructure (includes capital expenditure on all activities such as processing, manufacturing, distribution, design improvement, quality control, packaging, logistics, storage, warehouse, agriculture market produce infrastructure and excludes activity pertaining to front-end units, land cost and rentals) within three years.

Procurement requirements

At least 30% of the value of procurement of manufactured/ processed products needs to be sourced from Indian micro small and medium industries (agricultural co-operatives and farmers co-operatives), which have total investment in plant and machinery not exceeding US$2 million at the time of installation (without providing for depreciation).

The criteria of not exceeding US$2 million investment in plant and machinery should be reckoned only at the time of the first engagement with the retailer.

Even if this valuation exceeds US$2 million, the industry shall continue to qualify as a small industry during the course of the relationship with the said retailer.

This procurement requirement would have to be met, in the first instance, as an average of five years' total value of manufactured/processed products purchased, beginning 1st April of the year during which the first tranche of FDI is received; thereafter, it would have to be met on an annual basis.

First right to procurement

The government has the first right to procurement in respect of agricultural products.

Restrictions on location of retail outlets

Retail sales outlets maybe set up only in cities with a population of more than 1 million as per the 2011 census or any other cities, as decided by the respective State Governments.

FDI policy in MBRT is subject to the applicable state/union territory laws/regulations and accordingly; state governments can impose additional conditions.

e-commerce prohibited

Retail trading, in any form, by means of e-commerce, would not be permissible for companies engaged in MBRT in India

The FDI relaxation in MBRT provides foreign players with the opportunity to invest in India and cater to the world's fifth-largest consumer market. However, due to teething issues in the implementation of guidelines, it is essential for companies looking at investments in India to conduct an opportunity assessment and tailor their business models and strategies as per the Indian environment.

Source: EY Research



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Retailers Association of India (RAI) is the unified voice of Indian retailers. RAI works with all the stakeholders for creating the right environment for the growth of the modern retail industry in India. RAI is the body that encourages, develops, facilitates and supports retailers to become modern and adopt best practices that will delight customers. RAI has a three charter aim of Retail Development, Facilitation and Propagation.

Retailers Association of India (RAI) always strives to bring best practices to the retail industry and it's stakeholders. RAI's efforts center around advocacy and government representations, bringing best practices to the industry, fostering retail learning and training, creating a reservoir of information through retail research, disseminating communication through magazines, newsletter, website, etc. for the benefit of its members and the industry.

