Consolidation of the Indian Retail Industry

XLRI Jamshedpur
School of Business & Human Resources

Submitted By:

Birud Shah
Email Address: b06106@astra.xlri.ac.in
Contact No: +91-99315-82345

Siddharth Mehta
Email Address: b06111@astra.xlri.ac.in
Contact No: +91-99340-12472

Table of Contents

Tables:

Figures:

1.0 Introduction:

Over the last few years, retail has become one of the fastest growing sectors in the Indian economy. Organized retail in India is on an inflection point and is expected to grow by around 25 per cent per annum in the next 5-6 years. The sector is witnessing an influx of large domestic conglomerates such as Reliance Group, Bharti Group, Future Group, AV Birla Group and international conglomerates such as Wal-Mart, Marks & Spencer etc. who want to tap the retail opportunity. In addition, large investment announcements have been made both in the front as well as back-end operations of the industry. For instance Reliance industry has announced Rs. 25,000 crore investment into retail foray out of which about 35% to 40% will be spent in the rural retail mainly dealing with logistics supporting urban retail. But to reach the penetration of about 10% by 2011 the amount of investment required would be 52 billion according to KSA Technopak report.

Table 1: Size of Retail

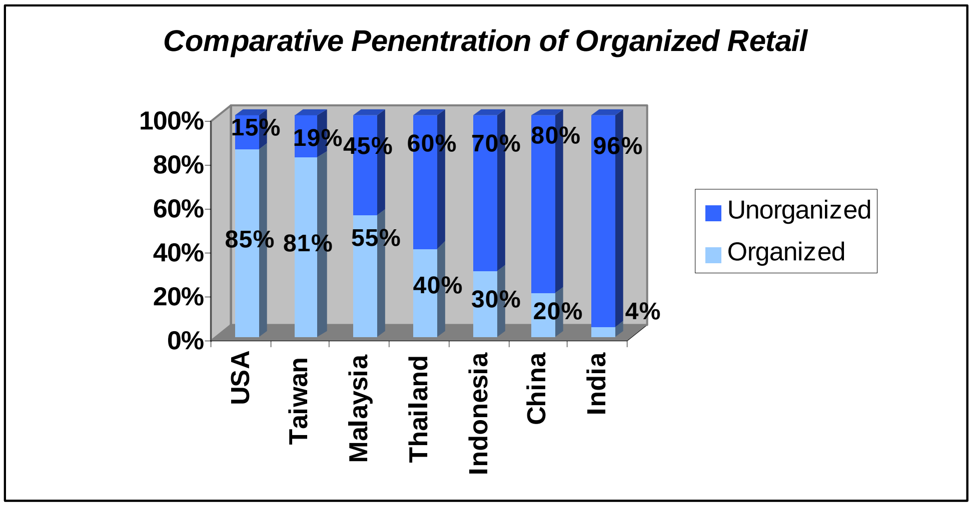
Size	2004 (Rs. Bn)	2010 (Rs. Bn)
Estimated size of retail in India	9300	14000
Share of Organized retail (%) in India	3	10-12
Size of organized retail in India	280	1400-1500

(Source: KSA Technopak)

1.1 The current state of Indian Retail Market-Highly Fragmented

Despite of being one of the hot sectors in India, retail is highly fragmented and organized retail is just 3% of the total retail market. There are about 12 million retail outlets spread across India, earning it the epithet of a “nation of shopkeepers.” More than 80% of these 12 million outlets are run by small family businesses which use only household labour. The following graph shows the extremely poor penetration of organized retail in India as compared to other countries.

Figure 1: Penetration of organized retail - Countrywise



(Source: Ernst & Young)

1.2 Consolidation in the Long Run:

With growing interest and powerful growth opportunities, in the long run, only a few players will dominate. Competition will intensify and the industry will witness consolidation. Once foreign direct investment (FDI) is permitted in the sector, India will see the entry of more global giants. When this happens, there will be rapid consolidation in few verticals like F&B, dairy products etc. Among international players, lifestyle and home segment retailers do not enter foreign markets as easily as value retailers. Advent of big international players like Wal – Mart, Carrefour, Tesco etc. will bring in best practices to India in all the aspects.

1.3 Future of Mom & Pop Stores – Are They Under Threat?

With industry consolidation and entry of big players, speculation is rife that future for Mom & Pop stores is bleak. The pie of organized retail is going to increase but not at cost of unorganized retail. New, innovative concepts will be developed which would ensure the co-existence of the Mom & Pop Stores with big players.

2.0 Indian Retail: The Competitive Environment

The following is the Porter's Five forces analysis of the Indian Retail Industry

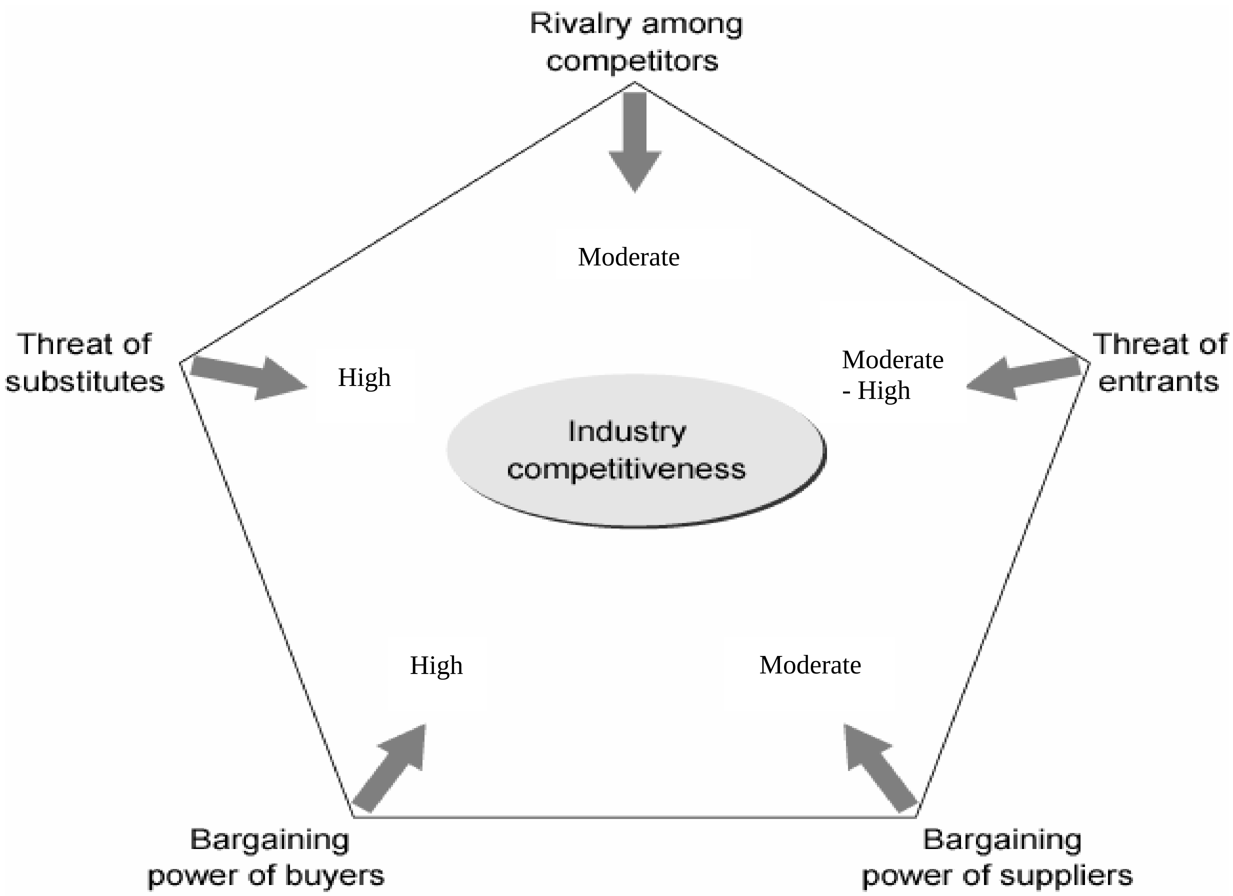


Table 2: Porter 5 forces analysis

Rivalry among competitors	• Limited number of competing firms in organized retail • Similar size of players • High growth rate
Threat of entrants	• International players looking to foray India • FDI policy not favorable for international players • Domestic conglomerates looking to start retail chains
Bargaining power of suppliers	• Large number of suppliers • Product differentiation is not high • Suppliers like Godrej and HLL are willing to integrate forward.
Bargaining	• Propensity to pay is low. Consumers are price sensitive.

power of buyers	• Rising income level enables large number of buyers.
Threat of substitutes	• Unorganized retail.

2.1 Overview of Drivers and Constraints of Growth

Table 3: Drivers and Constraints of Growth

	Growth Drivers	Constraints
Demand Side	• Economic Growth • Favourable Demographics • Urbanization of Tier II and Tier III cities	• Diverse customers segment to cater and changing buying behaviour.
Supply Side	• Credit availability	• High real estate cost • Lack of human resources • Inefficient logistics • Space availability • Lack of proper infrastructure

3.0 Value Creation and Innovations

3.1 Changing Modus Operandi:

With the number of players increasing and less product differentiation at the retail stores players are looking to innovative means to capture and retain customers. Innovation is taking place both, at the front end – new formats coming up, use of private labels, customer service and loyalty programs- and at back end- investments in infrastructure, newer business models and cutting the intermediaries in the supply chain.

3.2 The ever evolving formats:

In most emerging retail markets, such as Eastern Europe, Latin America and China, hypermarkets have been the major high growth format. Supermarkets dominate most cities, but there has been a clear shift towards hypermarkets, driven by the combination of good prices, overall shopping convenience and experience, product range and quality. In India, most hypermarkets are located within city limits as consumers do their shopping more than once a week. This is primarily because Indian consumers prefer fresh produce, have low car penetration and limited refrigeration space at home. Hence, there are only about 25 hypermarkets in India, operated by 4 major retailers. The 3 big retailers (Big Bazaar of Future Group, Star Bazaar of the Tatas and RPG Spencer) out of India’s top 5 retailers, already have aggressive hypermarket strategies in place. This is going to be one of the most preferred formats for international retailers entering India.

Intense competition will see new innovation in the future. For e.g. The Future Group has started a new formats called “Central” which they are projecting as destination stores for entire family. These stores are mammoth in size (in excess of 1,00,000 sq.ft.) and by next year they are planning to have Kolkata central with size of 4,80,000 sq.ft.

The innovation in formats is not limited to food & grocery or apparels but there are several other segments at which are being targeted by companies. For instance Future group has **Home Town** store which has all the necessary house décor items ranging from bedroom to wash basins. Retail activity could also be seen in entertainment segment where Adlabs, Inox and PVRs are battling for movie space. The following are some of the expected format changes by retailers

Table 4: Changing Format Preference

Retailer	Original Format	Later Format
RPG	Supermarket	Hypermarket, Specialty stores
Piramal's	Departmental stores	Discount stores
Future Group	Departmental stores	Hypermarket Supermarket Central
Raheja Group	Departmental stores(Shoppers Stop) Specialty stores(Crossword)	Supermarket(TBA) Hypermarket(TBA)
Tata Group	Departmental stores(Westside)	Hypermarket(Star India bazaar)

(Source: Crisil)

Rural India is witnessing different experiments. ITC is experimenting with retailing through its e-Choupal and Choupal Sagar – rural hypermarkets. HLL is using its Project Shakti initiative – leveraging women self-help groups – to explore the rural market. Mahamaza is leveraging technology and network marketing concepts to act as an aggregator and serve the rural markets. A common theme that emerges is the need for business model innovation to tap rural retail potential.

Big players which usually act as anchor store owners in a mall are tying up with the developers of the malls to attract crowd by providing special facilities. Mall management is a new field which is attracting attention of developers. Also new business models like the revenue shared business model (where revenue is shared between retailer and mall developer) are on rise.

It could be said that new formats will keep on evolving as competition stiffens and international players arrive in India. However, because of huge geography and varying demographics multiple formats will survive.

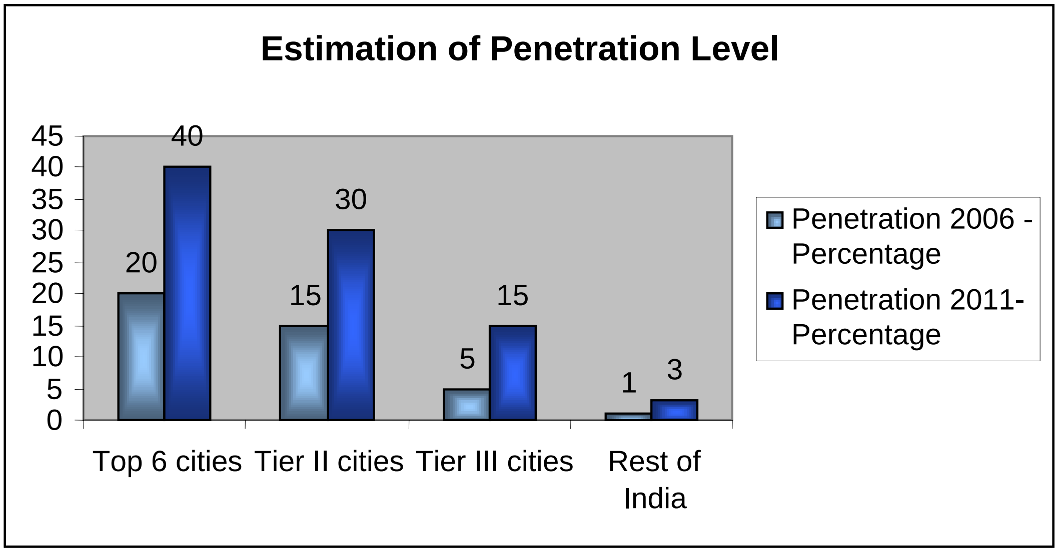
3.3 E-tailing:

Another concept which is slowly but surely gaining popularity is e-tailing or electronic retailing which provides the consumers the convenience of online shopping. Almost all the big players in the sector either have or are planning to come up with the online version of the shopping. A case in point is Lgezbuy.com portal launched by LG electronics. Although price may be higher in this form of retailing but it gives the consumer convenience and benefits related to online shopping. Such a format is very popular in developed countries like USA.

3.4 Movement towards Tier-II and Tier III cities:-

With the increase in consumer spending in Tier II cities and urbanization of Tier III cities, these cities are now attracting lot of retail activities. Players are moving to Tier II and Tier III cities to gain the first mover advantage. Also, the operational cost at these cities is comparatively low than the metro cities primarily because of high real-estate cost in the metro cities. A survey by CRISIL shows that top 60 cities will see the major organized retailing activity.

Figure 2: Citywise Penetration



(Source: Crisil)

3.5 Use of Private Labels:

A key strategy adopted globally and increasingly in India by retailers is the use of private labels or store brands. Globally private labels contribute to 17 percent of retail sales and are growing at 5 percent per annum. Private labels provide a higher margin to the retailers while simultaneously offering lower prices to consumers. A recent survey by AC Nielsen has identified that 56 percent of their survey respondents in India consider private labels to be good alternatives to manufacturer brands. In India, private label penetration is on the rise. The rapid growth of Indian retailers in the coming years will provide the necessary scale for many to launch an active private label program. In areas like consumer durables, the rapid development of original design manufacturers would facilitate easy introduction of private labels soon.

3.6 Product Differentiation – Key to success

As the retail industry is in the nascent stage it is unlikely that players will play the price war, which usually takes place in a mature industry. The players will however try to win the customers by product differentiation or by providing a unique shopping experience. Only basic daily usage high frequency- low value items would be sold at lower prices and once the market gets saturated price war may be witnessed in the other product categories also.

3.7 Specialty retailing

Learning from western countries, players are trying to capture the market share by bringing out formats catering to single verticals. Such chains are called specialty retailers or category killers. in the West. Many specialized stores have been set up with various food, apparel and footwear brands (both Indian and foreign) and companies like Godrej have already started furniture stores. Hindustan Lever Ltd, the FMCG major, is considering a retail chain for laundry products. Big players such as the Dubai-based Jumbo Group, Tatas and some small players are entering the electronics space. Other categories being explored by retailers are office products, toys, lingerie, chocolates, electrical products, paper products, stationery and furnishings. As these stores do not require much space, they will be set up as stores in malls rather than as standalone stores.

To summarize, retail sector is set to see whopping growth in next few years and the organized retail-pie is going to get bigger as urbanization of new cities take place. But for growth, large scale investments are required.

4.0 Consolidation in the Industry

As is expected in any growing industry, the last 18 months have seen a significant amount of deals and alliances in the Indian retail sector. The following are the major reasons for such frenzied activity:

- Bid to expand in new formats and offer a wider range of product categories
- Need for the domestic players to acquire a larger share of growing domestic market, in order to compete not just with the domestic competitors, but also prospective global retailers.

Table 5: Recent deals in the Indian Retail Industry

Year	Acquired/JV company Target	Acquirer	Nature of business	Stake	Consideration (US$ million)
2005	Liberty Shoes	Future Group	Retail (Footwear)	51%	3
2005	Indus-League Clothing	Future Group	Retail Clothing	68%	5
2005	Odyssey India	Deccan Chronicle Holdings	Leisure Retail chains (Books, music, toys)	100 %	14
2005	LandMark	Tata Trent	Books, music, accessories	76%	24
2006	Bistro Hospitality	TGI Friday's,USA	Restaurant (Food Retail)	25%	N/A
2006	Indus League Clothing	Etam Group, France	Lingerie and women's wear retailing	50% (JV)	8
2006	Wal-mart	Bharti	Cash & carry	JV	N/A
2006	Woolsworth	Tata	Electronic Goods	JV	N/A

(Source: PriceWaterHouseCoopers)

Table 6: Deals in the offing

Acquired/JV company Target	Acquirer	Nature of business	Proposed Stake
LV Trading, India	LVMH	Retail bags	51%
Fun Fashion, India	Fendi	Retail(Clothes, bags, accessories)	51%
Indus League Clothing	Lee Copper	Personal Care	50%
Piramyd Stores	AV Birla Group	Retail (Personal Care, clothes)	51%

(Source: PriceWaterHouseCoopers)

The following are some of the unsuccessful merger/acquisition attempts of the retail sector:

Table 7: Failed deals

Acquired/JV company Target	Acquirer	Nature of business	Proposed Stake
Subhiksha	Reliance Retail	Retail (F&B)	51%
Adani's	Reliance Retail	Retail (F&B)	51%
Starbucks	Tata	Retail (F&B)	N/A

(Source: PriceWaterHouseCoopers)

A Truly Innovative Strategy: Reliance

One strategy thought out by Reliance is to make the neighborhood Mom & Pop stores their franchises. The Mom & Pop stores would definitely like this proposition as they have severely disadvantages currently: Lack economies of scale, quality, great shopping experience or a compelling product mix. Most also don't handle fresh produce because the wastage is too high. Reliance proposes to take the headache of supply chain and store management and make them Reliance franchises, leading to better returns on investment. Thus it is a win-win proposition for both the parties. So the retail sector will continue to grow on the back of both, organized and unorganized retail

Also, with the Govt. permitting 51% FDI in single brand retail, global luxury brands like Christian Dior, Bvglari, Armani et al. are also setting up shop in India. But retailers have found out other ways to tap the vast Indian market as explained in the next section.

4.1 Gateway to India:

Due to the FDI restrictions the international players are looking for alternative avenues to enter the Indian markets. International Players like Metro, Lifestyle and luxury brands like Louis Vuitton, Gucci etc. already have their presence in India. Wal- Mart has tied up with Bharti to enter India and according to the agreement Bharti will look after the front-end and Wal-mart will take care of the back-end operations. The initial investment of around $100m in the deal could scale to $1.4b later. Electronic good retailer Woolsworth has similar kind of deal with Tata group. Most of the retailers coming to India are looking to start with cash and carry formats.

4.2 Foreign Retailers in India/Planning to be in India:

Table 8: Retailers in India/Planning to be in India

Players	Activity	Mode of entry
Metro AG	Food-retail	Wholesale operations
Benetton	Retail-apparel	Manufacturing
Marks & Spencer	Departmental Store	Franchise
McDonalds	Food-retail	Joint venture
Wal-Mart	Cash-n-carry	Tie-up with Bharti
Landmark	Lifestyle	NRI/OCB route
Nike/Reebok/Adidas	Footwear/Sportswear	Franchisee

(Industry Sources)

5.0 Investment required

To achieve the whopping growth predicted and to reach the organized retail penetration of 9.52 per cent by 2011, an investment of Rs 52 billion is required annually. This is arrived at by assuming a leased model of operation and does not include the cost of owning real estate. The estimate includes cost of furnishing, loss funding and working capital requirements (although retail is ideally a negative working capital business, working capital has been taken into account considering the early stage of business for players).

Table 9: Investment Estimation: Leased Model

	Units	2006-2011
Revenue(2006)	Rs million	530,125
Revenue in 2011	Rs million	1,796,758
Increase in revenue	**Rs million**	**1,266,623**
Revenue per sq.ft.	Rs/sq.ft.	10,000
Floor Space required	Million sq.ft.	127
Furnishing Rate	Rs/sq.ft.	1500
Cost of furnishing property	Rs million	189,993
Working capital required	Rs million	25,332
Working capital(% of revenue)	percent	2
Total capital invested excluding real estate	**Rs million**	**215,326**
Loss funding	Rs million	44,902
Investment required till 2011	Rs million	260,228
Investment per year	**Rs million**	**52,046**

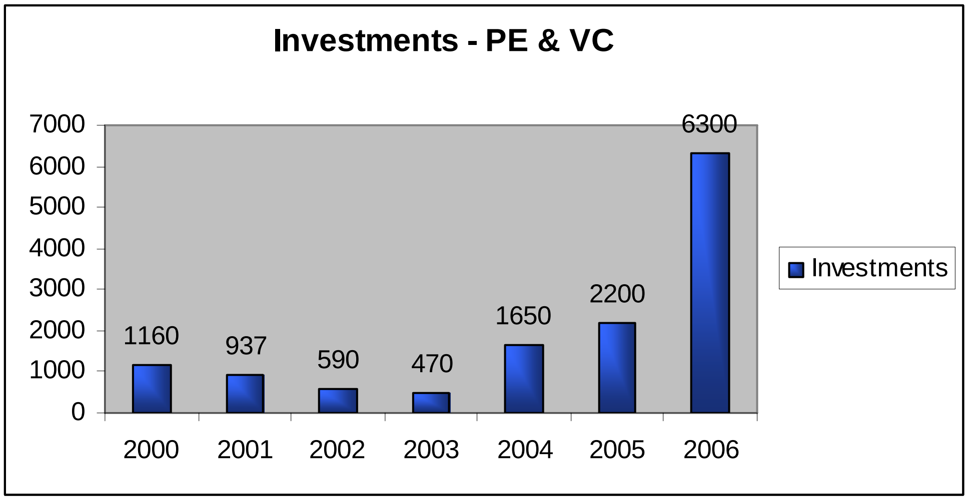
(Source: Crisil)

5.1 Investment Avenues

Venture Capitalist/Private Equity Funding

Over 44 US based VC firms are now actively looking to invest in startups and early stage companies in India. These firms have raised or are in the process of raising an average of $100 million each. Indeed if these 40 plus firms are successful in raising money, they would garner approximately $4.4 billion in the next 4-5 years. Taking PPP into consideration, this translates into $22 billion worth of investment. Since about $1.75 billion (40% of $4.4 billion) has already been raised, even if $2.2 billion is raised by end of year, there will be a glut of money for early stage investments. PE investments have been on a huge upswing due to the growing Indian economy as is evident from the following graph:

Figure 3: Investments

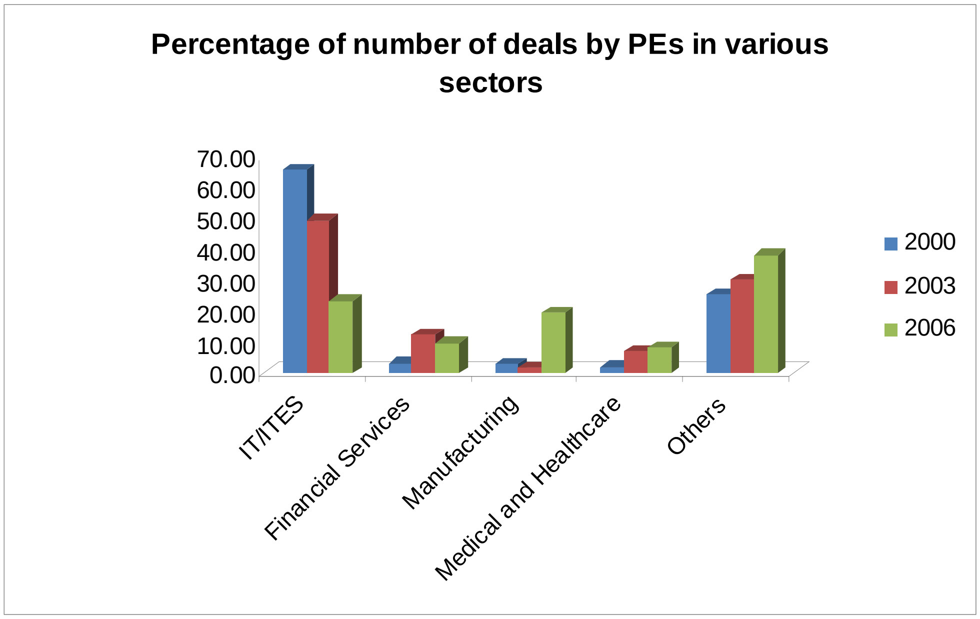


(Source: Evalueserve)

Given that a typical startup requires $9 million during first three years and even assuming the startup survives 3 years, investing $2.2 billion would imply investing in 150-180 startups every year in 2007-10, which seems impractical if PEs and VCs concentrate on their current favorite sectors of BPO, IT, Telecom and Internet. This leads to the next sunrise sector investment namely retail, real estate, infrastructure, media and entertainment etc.

The growth in interest among PE/VCs is evident from the following graph:

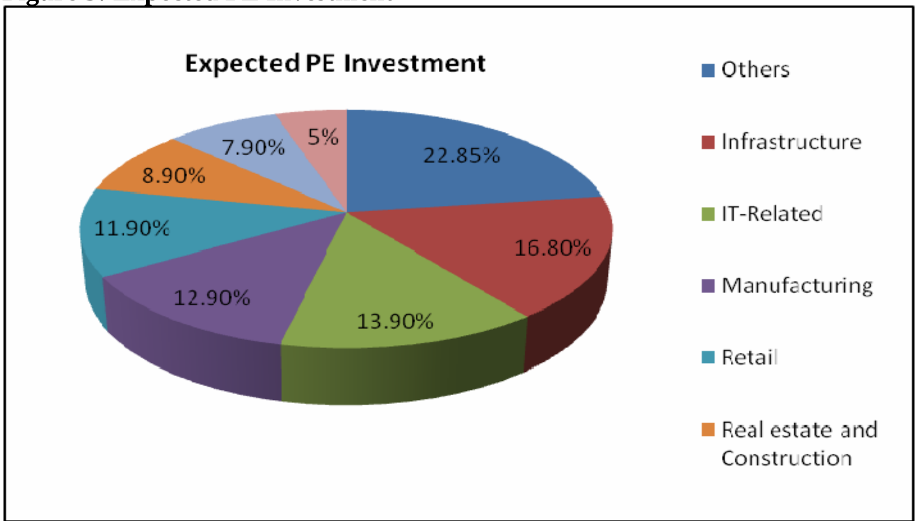
Figure 4: PEs in various sectors



(Source: Evalueserve)

As is evident from the above 2 figures, there has been a huge increase in the value of PE investments and also a percentage increase in the PE investments in Others (comprising retail, real estate etc). Thus the net increment of PE investments has been huge in India over the last 3 years.

Figure 5: Expected PE Investment



(Source: Deloitte Corporate Finance Services)

The profitability expected out of the retail sector in India as compared to other Asian countries is very high as is evident from the following chart – further incentivizing PE/VC investments

Table 10: Expected turnover over next year

	Gross Turnover			
	Percentage of respondents			
	Asia	Greater China	South East India	India
Improve	75%	73%	73%	95%
Stable	23%	25%	24%	5%
Worsen	2%	2%	3%	0%

(Source: Jones Lang LaSalle-Meghraj)

Table 11: Expected profit over next year

	Profit Margin			
	Percentage of respondents			
	Asia	Greater China	South East India	India
Improve	46%	46%	43%	50%
Stable	47%	48%	48%	45%
Worsen	7%	6%	9%	5%

(Source: Jones Lang LaSalle-Meghraj)

This clearly justifies the strong PE interest in the retail sector of India

Certain firms like Oak Investment Partners have already set up a $200-$250 million venture fund to focus on retail boom in India.

6.0 Future outlook

6.1 Short Term (2007-2009)

Greater clarity is required in the Govt policy of FDI in retail. Without a proper regulatory mechanism, the entry of big foreign players will be hampered in the short run. However, they may tie up existing Indian players or form a JV like Wal-

Mart to enter the Indian market. However domestic players like Reliance and Subhiksha are expected to aggressively follow their growth strategy to cement their place before foreign players are allowed. The Mom & Pop stores in the short run will be adversely affected in the urban areas but in the rural areas they will still be the dominant force.

6.2 Medium Term (2009-2011)

Big domestic players are expected to acquire smaller players like Trinethra, Adanis, Nilgiris etc and further consolidate their position. This will lead to further economies of scale and also bring about efficiencies in the supply chain and retail management areas. In the next phase of industry growth, the big players will start targeting the semi-urban and rural areas. The Mom & Pop stores will improve their supply chain efficiency to stay competitive.

6.3 Long Term (2011 onwards)

With increasing pressure from foreign governments, India ultimately will open up its retail sector for foreign investment. There will be a huge number of players entering the Indian retail market. Organized retail will increase. But since India is such a vast country with so many disparities, the Mom & Pop stores will survive and in the long run will become franchises for the big retailers.

7.0 Glossary

Tier I cities: Five metro cities of India namely Delhi, Mumbai, Chennai, Kolkata, Bangalore are the Tier I cities.

Tier II cities: The mini –metro cities namely Pune, Ahmedabad, Hyderabad, Chandigarh constitute the Tier II cities.

Tier III cities: The upcoming cities like Surat, Nagpur, Vadodara, Indore etc. are the Tier III cities.

Revenue Shared Model: In this model retailer pays less rentals to the owner but shares his revenue with the owner.

8.0 References

- Crisil Research Reports
- Evalueserve Research Reports
- Jones Lang LaSalle-Meghraj Retailer Sentiment Survey
- Ernst & Young, The Great Indian Retail Story 2006
- KSA Technopak Reports
- AT Kearney, GRDI 2006.
- KPMG – Indian Retail on Fast Track
- CII retail report
- FICCI research report
- PriceWaterHouseCoopers M&A Bulletin
- Deloitte Corporate Financial Services Report
- http://www.valuenotes.com/one-time/IndianRetailSector_11oct06.asp?ArtCd=86179&Cat=&Id=