



India

India

ECONOMIC OVERVIEW

GDP and CPI

The Indian economy grew at a rate of 7% in 2004, following the 8.6% growth experienced in 2003. The growth momentum was sustained despite an insufficient monsoon, increasing global oil and steel prices, and reduced growth rate in the agriculture and allied services.

The Indian economy has moved from being dependent on agriculture to services, which are now the key driver of the Indian economy. Information Technology (IT) and IT-enabled services (outsourcing) have been a key contributor in making India a global services destination, a trend that is expected to continue and grow at a rapid rate. On the other hand, agriculture and allied activities' share of the economy has declined from 31.5% in 1996-97 to 22.2% in 2003-04. Industry's share remained broadly unchanged at 21%-22%.

The economic growth was accompanied by moderate inflation of 4.0% during the past five years and CPI in 2004 was 3.8%, which was unchanged from 2003.

GDP and CPI

	2001	2002	2003	2004
GDP growth (%)	5.2	4.1	8.6	7.0
CPI (%)	3.8	4.3	3.8	3.8

Source: EIU, July 2005

Unemployment

Given its large population base and relatively low GDP per capita, unemployment and poverty remain key challenges to India's future development, particularly as agriculture continues to be the dominant sector for providing employment in rural areas.

Unemployment

	2001	2002	2003	2004
Unemployment rate (%)	9.2	10.5	10.4	10.1

Source: EIU, July 2005



Area ('000 sq km)¹: 3,300
(US 9,600 – EU25 3,981 – World 133,700)

Capital²: New Delhi
(Nber of inhabitants: 19 million)

Population (million)³: 1,080
(US 293 – EU25 455.9 – World 6,376)

GDP (USD billion)³: 658.2
(US 11,735 – EU25 12,723 – World 39,503.5)

GNI per capita (USD)¹: 540
(US 37,870 – EU25 22,810 – World 5,110)

Currency: Indian Rupee (INR)

Languages: Hindi, English, regional languages

Main religions: Hindu, Muslim, Christian

Government type: Federal Republic

Sources: CIA Factbook; (1) World Bank 2005; (2) City Population; (3) Economist Intelligence Unit 2004 data

Economic forecasts

Near-term forecasts estimate GDP will grow at the rate of 7.1% in 2005, sustaining the expectation of continued growth in services, industry and infrastructure. Inflation is expected to marginally increase in the near term due to an increase in oil/energy prices in global markets.

The unemployment rate is expected to fall from the present base of 10% to around 9.1% by 2007.

Key economic forecasts

	2005	2006	2007
GDP (%)	7.1	6.8	6.6
CPI (%)	4.3	4.3	4.4
Unemployment rate (%)	10.0	9.3	9.1

Source: EIU, July 2005

REGULATORY ENVIRONMENT

Foreign direct investment

Foreign investments into India are governed by the Foreign Direct Investment (FDI) Policy of the Government of India and the Foreign Exchange Management Act, 1999 (FEMA). Foreign investment is permitted in virtually all sectors, except those falling under strategic concerns that are not eligible for automatic route investment. The FDI policy is framed by the Indian Government and is implemented by The Reserve Bank of India for cases falling under the automatic route (i.e., without requiring prior approval) and The Foreign Investment Promotion Board (FIPB) for all other cases.

The FIPB (which falls under the Ministry of Finance) is an empowered government board comprising members of various central government ministries and is the nodal agency for all FDI matters.

Prior to 1997, while the FDI policy recommended specific FIPB approval in trading, FIPB had also considered and approved, on a case-by-case basis, applications under the retail-trading segment. For instance, Foodworld, which is a 51:49 joint venture between RPG group and Dairy Farm International of Hong Kong, was established during this period and is today one of the leading food retailers in India.

Since then, the policy has undergone change and the current FDI regime permits retail trading, subject to FIPB approval, only in the following cases:

- High-tech items/items requiring specialised after-sales service
- Social sector items
- Medical and diagnostic items

- Items sourced from the Indian small sector (manufactured with technology provided by the foreign collaborator)
- Two-year test marketing (simultaneous commencement of investment in manufacturing facility required)

Foreign-owned Indian companies cannot own and operate retail outlets, other than for those items identified above. However, on a case-by-case approval basis, 100% FDI may be permitted in trading companies carrying out the following activities:

- Export trading
- Bulk imports with sales either through custom bonded warehouses or high seas sales
- Cash and carry wholesale trading
- Sales substantially to group companies

Up to 100% FDI is allowed in e-commerce activities subject to the condition that such companies would divest 26% of their equity in favour of the Indian public in five years, if these companies were listed abroad. Further, these companies can engage only in business-to-business (B2B) e-commerce and not in retail trading, *inter alia* implying that existing restrictions on FDI in domestic trading would be applicable to e-commerce as well.

The retail sector in India is presently dispersed, widespread, labour intensive and an overwhelming 97% of it is unorganised. The government has been deliberating on the issue of lifting the restrictions on FDI for some time. The Indian Prime Minister's Office is directly monitoring an initiative to open up the retail sector to FDI soon. It is most likely there would be a calibrated opening (up to 51% equity permitted to the foreign partner), and collaterals/conditions of investment such as minimum investment, size of stores, locations, local sourcing etc.

FDI

	2001	2002	2003	2004
FDI (INR bn)	234,233	229,416	262,740	253,982
FDI (USD bn)	5.35	5.24	6	6.5

Source: EIU, July 2005 (Exchange rate: December 31, 2004)

Property/Real estate regulations

Real estate for retail sector

The previously restricted real estate sector was opened for FDI in February 2005. Subject to certain minimum area and capitalisation conditions, up to 100% FDI is now permitted under the automatic route in townships, housing, built-up infrastructure and construction development projects (including housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure). Indian companies developing retail space can now be 100% foreign owned provided they have a minimum built up area of 50,000sq m.

Scarcity of quality real estate at affordable rentals has traditionally been a key challenge to growth in India. However, the retail boom that is being witnessed in India today is likely to have a significant impact on the commercial real estate sector. Presently, most of the major Indian cities have significant commercial projects under construction for retail purposes and, due to demand and supply interplays, there has been some rationalisation in property prices across the country.

However, the majority of new shopping malls being developed remain fragmented and sub-optimally planned in terms of positioning infrastructure. In the near future, there is a likelihood of a shake out within the shopping malls business with the emergence of a few large dominant national/regional players that are relatively more professionally managed and a host of speciality/niche local players. With the expected globalisation of the country's retail sector, shopping malls of international scale and quality should also emerge soon. An increased alliance/partnership between large regional real estate developers and national retail companies on joint development/management of retail real estate catering to the pan-Indian or regional growth plans, and other synergies between specific retailer(s) and mall developer(s) can be expected.

It is difficult to find suitable properties in central and downtown locations for large-format retail stores in most metros, primarily due to fragmented private holdings and infrequent auctioning of large government-owned vacant lands. This has led to a shift in preference to the suburbs of metropolitan cities. There has been a spurt of shopping malls in these areas; some examples are Gurgaon and NOIDA near Delhi, and Bandra Kurla Complex and Navi Mumbai near Mumbai.

The key implication for retailers is that advance planning with respect to market expansion is necessary since, not only is identification of optimal property challenging, the cycle time between identification and possession of ready-to-move-in retail property is rather long, typically between 18 and 24 months.

Property regulations

As discussed above, there has been a shortage of quality retail space in central and downtown locations, and rents are high for what is available. Compounding these shortages are the following problems:

- Very high stamp duties on transfer of property that vary state to state (12.5% in Gujarat and 8% in Delhi).
- Urban Land Ceiling Act and Rent Control Acts have distorted property markets in cities, leading to exceptionally high property prices.
- Presence of strong pro-tenancy laws makes it difficult to evict tenants; augmented by problems of clear titles to ownership.
- Land-use conversion is time consuming and complex.
- Time consuming legal process for property disputes.
- City urban planning projected smaller commercial plots and this, along with rigid building and zoning laws, makes it difficult to procure retail space.
- Occupancy cost may marginally increase for retail outlets at malls with the imposition of service tax on certain services connected with management of commercial real estate (as proposed in the Union Budget 2005-06).

Other Regulations

Tax

Sales tax rates differ across states, making supply chain management a challenge for organised retailers. Inter-state sales attract central sales tax while, for some categories of product, certain states levy import taxes, namely entry tax, on goods entering their territory. Simultaneously, states levy export taxes when the goods are moved for sale outside the respective states. Other than state taxes, local bodies (e.g., municipal corporations) levy local entry taxes in some locations.

In order to streamline the domestic commercial taxation system the government has introduced value added tax (VAT) from 1 April 2005. It has, however, only been partially implemented as only 21 states and five union territories have agreed to implement VAT. The remaining states will continue to be governed by the sales tax laws until such time as they switch over to VAT.

VAT would have a very strong bearing on the consumer and retail sector. Most of the retail traders are not liable to pay tax, as the first seller is paying the tax. Under the VAT regime, tax is levied on value addition at each stage of sale, thus ensuring that all the retailers are covered in the tax net. However, small retailers will be kept out of VAT and only retail traders with annual turnover exceeding Rs1 million are required to obtain VAT registration. Retailers with turnover in the range of Rs1-5 million have the option of paying composition tax or VAT. Retail traders already registered under the sales tax regime are automatically registered under VAT.

In order to implement VAT successfully, the government needs to further develop the organised retail sector in India. Retailers' margins will not be adversely affected as no additional costs are being imposed on them; the resulting increases in prices are typically recovered from customers. As a result of the VAT, it is likely that, in the medium term, prices of goods will stabilise and in the longer term, business overall will grow. Over time, therefore, VAT will be good for business.

Imports

Customs or import duties are levied by India's Central Government on goods imported into the country, based on the tariffs prescribed for such goods. Duty is levied on the transaction value of the imported goods at the rate of duty specified in the Customs Tariff Act, 1975.

The median rate of customs duty for non-agricultural products has been brought down to 15% in 2005 from 20% in 2004 and from 40% previously. However, there are a number of basic tariff levels plus an additional duty depending on the good. In some cases, depending on their end use, certain goods are fully or partially exempted from levy of customs duty. Most consumer goods generally attract a 15% median rate of basic customs duty. An additional customs duty can also be levied on consumer goods at the rate of 16%.

As one of the founding members of the World Trade Organization (WTO), India has agreed to bind its customs tariffs to the rates specified in the Schedule of Concessions in accordance with Article II of the WTO Agreement. These commitments restrict India from raising its tariff levels beyond the limit specified in the Schedule of Concessions. Further, India has gradually removed quantitative restrictions in accordance with the commitments made to the WTO.

India is also a signatory to the Information Technology Agreement (ITA) under the WTO, whereby it has committed to reduce basic customs duty on specified goods to 0% by 2005. In view of this, the basic customs duty on all specified ITA items has been reduced to 0%. However, an Additional Duty of Customs, generally 16%, in lieu of excise duty would still be levied. Also, an Additional Duty of Customs at 4% in lieu of sales tax/VAT has been introduced. This levy is only on the items specified in the ITA.

Recent reductions in various customs duty rates below the bound rates indicate the Indian Government is continuing its efforts to rationalise and align duty rates in accordance with the rates prevailing in Southeast Asian countries. With the implementation of WTO norms and further removal of restrictions from the import regime, the retailing sector outlook appears bright.

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

Population

Population evolution

India's population, estimated to be 1,080 million in 2004, is expected to grow by 1.7% this year.

Population

	2001	2002	2003	2004
Population (m)	1,034	1,050	1,065	1,080

Source: EIU, July 2005

Population by age group

The proportion of the Indian population in the consuming age class (15-64) will increase over the next few years with more than 60% of the population (an estimated 720 million people) in this age group by 2010 compared to 58% in 2005 (an estimated 660 million people). The ratio of non-working population to working population (dependency ratio) will decline over the next few years.

Age profile

% of total population	1998	2003	2008 (f)
0 – 14 years	34.4	32.2	30.0
15 – 64 years	61.0	63.1	64.9
Over 65 years	4.6	4.8	5.1

Source: EIU, August 2004

Projected age profile

% of total population	2005	2010	2015
0 – 14 years	33.7	31.5	29.6
15 – 64 years	61.6	63.6	65.2
Over 65 years	4.7	4.9	5.2

Source: Statistical Outline of India 2004 – 05

Urbanisation of the population

Growing urbanisation is a key trend in the country, with the rural population growth averaging 17.9% and urban growth 30.7% for the period 1991-01.

Urban/Rural split

% of total population	1998	2003	2008 (f)
Urban	27.8	29.6	31.8
Rural	72.2	70.4	68.2

Source: EIU, August 2004

Income/Buying power

The average Indian income in real terms was USD270 for 2003-04 and is expected to increase by 5.2% in the 2004-05 financial year. In the income class segments, the upper-income class had a 21.5% compounded annual growth rate (Cagr) during 1995-96 to 1998. The upper-income classes are rising faster than the lower-income ones and the lowest segments are shrinking.

With growing disposable income and the highest ever consumer confidence levels, Indian consumers propensity to spend is soaring. Private final consumption expenditure (PFCE) rose by 8.3% during 2003-04, the highest growth rate in 23 years. Indians purchasing power is further fuelled by easy availability of finance in the form of loans.

Income, Expenditure and Savings

(INR)	2001	2002	2003	2002–2003 (%)
Personal Disposable Income	1,790,828	1,967,577	2,108,935	7.1
Private Final Consumption Expenditure	1,360,018	1,494,050	1,591,132	6.5
Household Sector Savings	458,215	519,040	559,258	7.8

Source: Reserve Bank of India

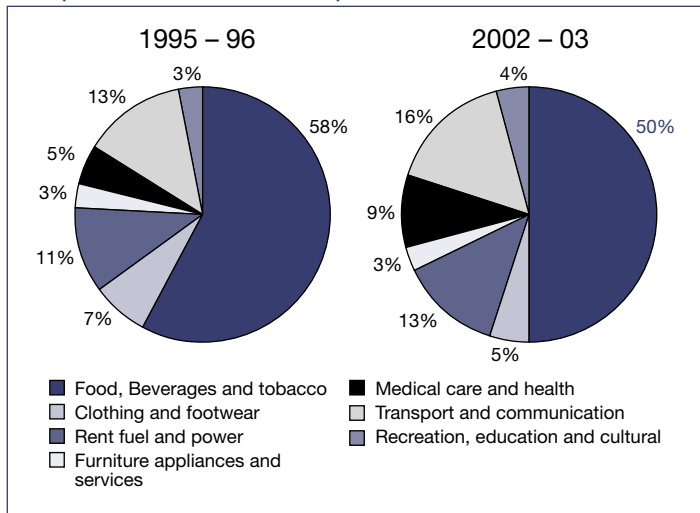
Consumer behaviour

Average household spending patterns

Indian consumer spending has grown at an average of more than 11.5% a year for more than a decade. As in most developing nations, a large chunk of Indian's consumer expenditure is on basic necessities, especially food-related items. Hence it is not surprising that food, beverages and tobacco account for as much as 50% of consumption expenditure in 2004. The remaining 50% related to non-food items is expected to rise, due to the growth of per capita income.

Consumers today place a great deal of emphasis on "quality of life", and expenditure on aspiration-driven goods and services (cars, mobile phones, consumer durable, vacations etc.) have grown significantly. Prominent over the years are the variances in the spending behaviour of consumers. Medical and healthcare spending has increased from 3.5% in 1992-93 to 8.06% in 2002-03, a Cagr of 19.71%. Similarly, spending on recreation and transport has almost doubled.

Composition of household expenditure, 1995 – 96 vs. 2002– 03



Source: Businessworld Marketing Whitebook 2005

Lifestyles/Shopping habits

Lifestyle in India is shifting from austerity to complete self-indulgence. This phenomenon can be attributed to various factors, for instance admiration of capitalism, dual-income nuclear families, a gradual shift towards a credit-based economy and aspirations of a global lifestyle. The consumer today spends to achieve the "feel good" factor. Some of the direct beneficiaries of the phenomena are health/well-being centres, food, hospitality industries and the travel industry. For instance, six million Indians travelled abroad last year.

Shopping has evolved from a need-based activity to a leisure-time entertainment. Large numbers of urban women, especially from nuclear families, are working. As a result, the concept of time poverty has crept in. Convenience is gradually overriding price consideration; this is especially true for a certain class of urban households.

Brand/Price sensitivity

For years the scale of brand/price tipped the price side. Today, the consumer is discerning and equates brand to a certain added value. India has consumers displaying their preference for brands. This is rather surprising in a country as diverse as India, where past loyalties have changed for a 10% difference in pricing for price-sensitive products.

The Indian consumer is more price conscious compared with most overseas counterparts, primarily on account of a fragmented market structure, and a high degree of differential pricing structures between national brands and unbranded goods and services. The Indian market is characterised by a strong presence of the unorganised and unbranded sector. This is primarily due to limited entry barriers (technology), exemptions and reservations of certain items for the small-scale sector (i.e., a maximum limit on investments), and the problems encountered by large, national players reaching out to remote, rural areas given the size of the market and the poor infrastructure. Even the more affluent classes prefer to shop at discount stores for basic daily necessities. Striking the value-for-money equation right is one of the most critical success factors for both branded goods manufacturers and retailers.

RETAIL & CONSUMER SECTOR PERFORMANCE

Major consumer goods players

The list of top consumer goods companies in India includes food and beverages, personal care and clothing manufacturers. The list comprises a healthy blend of brands from the stables of multinationals and homegrown groups. Hindustan Lever Limited (HLL), the fast-moving consumer goods (FMCG) leader (a subsidiary of Unilever) and a conglomerate, has a product portfolio ranging from personal care products to food products. Recently, HLL's food products portfolio was trimmed by 60% in order to maximise the upside from marketing and promotion efforts.

In an effort to attract investments, state governments have offered various tax incentives that have led to unprecedented investment activity in the consumer industry. Increased margins are expected due to tax

savings and manufacturing efficiencies. Companies that have made substantial investments in expanding their product portfolio and distribution dominate the top-ten fastest growing companies in the FMCG industry.

Currently, 50% of consumer goods sales of top companies are from rural areas. However, despite the high component of rural sales, rural penetration rates are still low. To offset the problem, companies are customising and adapting models to suit the rural areas. With the cost of technology decreasing, several companies are attempting to create virtual bazaars/kiosks or agri-portals. The most prominent virtual bazaars are ITC's e-choupal, IndiaArgiline by EID Parry and the Dairy portal by Amul. The kiosk serves a dual purpose for the farmers to sell their produce to the consumer, and for the company to directly purchase and sell products and services from and to the farmers.

Key consumer goods companies

Rank	Company name	Category of products	Net sales (USD m)	Year
1	Hindustan Lever Limited (subsidiary of Unilever plc)	Personal care products, detergents and food	2,230	December 04
2	ITC Limited (subsidiary of BAT)	Tobacco, food, apparel, paper and packaging	1,698	March 05
3	Ruchi Soya	Food	860	March 05
4	Videocon International	Consumer durables	828	September 04
5	Tata Tea Consolidated	Tea and beverages	684	March 05
6	Gujurat Co-operative Milk Marketing Federation (Amul)	Dairy farm products	643	March 04
7	Nestle India Limited	Food and beverages	495	December 04
8	Nirma	Personal care products and detergents	484	March 04
9	Asian Paints	Paints	446	March 05
10	Indian Rayon and Industries Limited	Textile and apparel	442	March 05
11	Arvind Mills	Textile and apparel	373	March 05

Source: Company information

Food & beverages

Consumer expenditure on food, beverage and tobacco has fallen from 58% in 1995 to 50% in 2002-03, yet the Indian-branded food and beverages market grew by more than 5% according to a report on global trends in food and beverages. This is indicative of the growing consumer pie.

The time-poverty concept and increased propensity to consume have driven the growth of packaged food and ready-to-eat segment in India. The food processing industry is estimated to be USD70 billion. Basic commodities such as oil and milk make up more than 60% of all processed foods sold, which is not surprising as India is the world's largest producer of milk. As only 6% of all perishables are processed, the government permitted foreign investment in food processing and lowered import duties on refrigerated vans and on foods. This has led to an increase of foreign food labels in stores.

ITC, India's conglomerate with interests in tobacco, hospitality and agricultural products, among others, has recently added biscuits, conserves, cooking pastes, ready-to-eat dishes and pasta to its earlier menu of cooking oil and packaged flour. The food segment chipped in a small contribution towards revenue in the past, but its share doubled last year. The revenue for food segment has been classified into "others" which includes other products like incense sticks etc.

Health conscious consumers have perpetuated growth in the fresh fruit beverage segment. Dabur and Godrej, both leading Indian consumer companies manufacturing fresh fruit juices, are on an expansion spree to service the rising demand.

Electronics

The Indian consumer durable industry, estimated at USD4.4 billion, has shown strong growth in categories like flat-screen televisions and frost-free refrigerators. Competition has become fierce in this segment, with major multinational companies, such as Sony and Samsung, battling for market dominance. New participants in the segment are Hyundai and Haier. Keeping up with the trend in the industry, Haier India intends to widen its presence in the country by investing USD200 million in a local manufacturing facility.

Consumer electronics is experiencing robust growth – flat-screen TVs grew at 90% during 2003. Considering the low penetration levels of consumer durables, increased activity in the segment is to be expected. Telecommunications is the other hot segment; studies have tipped India to remain

the highest growth market in the Asia-Pacific region. Spoilt for choice, the consumer has fifteen international mobile phone brands to choose from. As a large portion of mobile phones sold in the country are imported, Nokia has announced plans of setting up a manufacturing plant in South India to leverage the market position it enjoys in the country.

Clothing

From the 1960s through to a large part of the 1990s, ethnic wear dominated the Indian's wardrobe. Fashion styles have changed and taboos relating to dressing behaviour no longer exist. The modern Indian consumer is not just wearing clothes, but extensions of their personality.

It is estimated that apparel sales in retail stores have posted a growth of 25-30% in 2003. With demand driving supply, most apparel manufacturers are sitting on a sweet spot. Apparel manufacturers fall into two categories: contract manufacturers for private labels or exporting and the manufacturing retailer. Contract manufacturers for private labels are gaining prominence, with department stores retail margins on the sale of private labels 30-50% higher than those on branded clothing. Manufacturing retailers, such as Arvind Mills, service the demand for merchandise by undertaking the manufacturing themselves.

Watches

The watch industry is the most organised sector in terms of retail sales. Watches have transitioned from being a necessity to a fashion accessory. The premium watch category, priced USD222 and above, is growing faster than other segments in the past three years. For that reason, India has emerged as one of the key markets for international watch brands. It is reported that the international Swiss watchmaker, Swatch Group India, which was set up in January 2002, is growing at 50% per year.

Working with the trend in the industry, premium watchmaker Jaeger LeCoultre launched a range with a starting price of USD3,500, and is among the many others, including Bvlgari, Patek Philippe, A Lange & Sohne and Cartier, that the Indian consumer can choose from.

Major retail players

Retail sales

Retail sales account for 10% of the GDP in 2004, with a market size of USD207 billion, and the sector is expected to grow at 15.6%. The share of the organised sector is USD6 billion, constituting 3% of the total market size.

Retail sales growth

	2002	2003	2004
Total sales (USD bn)	164	179	207
Growth rate (%)	N/A	9.5	15.6

Source: Industry Estimate, PwC Analysis

Breakdown by number of stores

	Hypermarkets	Supermarkets	Discount stores	Convenience stores
2004	21	508	404	240
2003	7	468	174	124

Source: Industry estimates, PwC Analysis

Key food retailers

Retail formats	Group name	Store brands	Number of stores	2004 net sales (USD m)
FOOD & GROCERY				
2004-05				
Hypermarkets	Pantaloon Retail	Big Bazaar	19	72
	Tata Trent	Star India Bazaar	1	N/A
	Shoprite Checkers	Shoprite	1	N/A
	RPG	Spencer's (Giant)	3	33
Supermarkets	Nilgiris	Nilgiris	32	33
	RPG & DFI	Foodworld*	93	78
	Apna Bazaar	Apna Bazaar	86	33
	Zakaria Shahid Group	Sabka Bazaar	24	N/A
	Trinethra Super Retail	Trinethra	92	24
	Pantaloon Retail	Food Bazaar	31	N/A
Discount	Viswapriya	Subhiksha	164	50
	Margin Free Markets	Margin Free	300	N/A
Convenience stores	Bharat Petroleum Company (BPCL)	In & Out	240	N/A
Cash and carry	Metro Cash & Carry	Metro	2	N/A

Source: Industry estimate, PwC Analysis

*In May 2005 it was reported that RPG and Dairy Farm International (DFI) dissolved their joint venture. DFI will continue operations with the Foodworld brand and retain control of the 30 Health & Glow (Health & Beauty format) stores. RPG's share of stores will retail under the brand of Spencer's.

Key specialty stores

Retail formats	Group name	Store brands	Number of stores (2004)	2004 Net sales (USD million)
SPECIALTY STORES				
Home equipment (electrical goods, furniture)	Godrej & Boyce Retail division (Furniture)	Godrej	36 (2003)	N/A
	Zakaria Shahid Group	Home Stores	13	N/A
	Vivek Group	Vivek Ltd	46	45
	KK Birla Group	Style Spa World Furniture	70	N/A
Books/Music/Jewellery etc	RPG	Music World	172	14
		Health & Glow *(personal care)	30	6
	Bennet & Coleman	Planet M (music)	39	12
	Rosy Blue Group	Intergold/ Orra (jewellery)	24	13
	Tata	Tanishq	69	N/A
	Shopper's Stop	Crossword	26	N/A

Source: Industry estimate, PwC Analysis

* Health & Glow would be owned independently by DFI

Food retail channels

Hypermarkets

The hypermarket format is most suitable and appealing to the Indian consumer. The concept of hypermarkets is new to India and accounts for a negligible proportion of food sales. The largest retailers operating in this format are Pantaloon Retail with Big Bazaar, RPG Enterprises with Giant (now Spencer's) and Tata Trent's Star India Bazaar hypermarkets.

Most retailers are likely to continue expanding in the larger Indian cities and select tier-two cities with potential for growth. Some of the trends in the hypermarket format are a rapid growth in revenue led by volumes, and expansion in both large and medium cities. South Africa's Shoprite is the latest to make its debut in India in this format. With increasing numbers of players in hypermarkets, competition is likely to intensify, possibly resulting in pressure on margins.

Supermarkets

Last year, about 40 new stores were added by leading supermarket chains. The contribution of supermarkets to food sales is currently minimal, essentially due to prevalent competition from the large number of traditional retailers in terms of price and reach. Clientele of supermarkets consist mostly of affluent Indians who are not too price-sensitive, prefer convenience, hygiene and the attractive atmosphere. As such, supermarkets are expected to expand at a high rate, especially with the growing numbers of higher-income Indians.

Large players operating through these formats include Food Bazaars from Pantaloon Retail, RPG's Foodworld supermarkets, Trinethra supermarket and Nilgiris.

Discount stores

Most traditional food retailers compete on price, offering discounts to attract customers. Due to inefficiencies in supply chain management, proliferation of discount stores is limited. The most prominent discount grocery chains are Subiksha (leader) and Margin Free Markets.

This format is expected to witness increased popularity, with large retailers consolidating positions and thereby achieving market efficiencies.

Convenience stores

K.K Modi Group has opened the first of its proposed chain in the convenience and 24/7 store format. However, “paan” shops, which double as convenience stores, are found on almost every road. Paan shops are popular because of their long opening hours and their large number (more than one million at present), which make them easily accessible.

Non-food retail channels

Department stores

Retailers in this channel are evolving, attempting to differentiate their offering by innovating and adopting alternative formats. For instance, Pantaloon Retail launched Bangalore Central, a seamless mall that is one of its kind in the country. The size of the store is based on the catchments and region. Large formats are adopted for major urban cities while smaller ones for tier-two cities.

Given the premium nature of the stores and retailing lifestyle products, scalability of the model is limited.

Key department stores

Company name	Group	Number of outlets 2004/2005	2004-2005 net sales (INR m)	Future plans
Shoppers Stop	K Raheja Group-Real Estate	19	5,112	11 new stores by 2005. Venturing into food retailing
Westside/Star Bazaar	Trent Ltd.	17	2,345	6 new stores by 2005. Venturing into food retailing
LifeStyle	Landmark Group	7	3,060	12 new stores in two years. Venturing into food retailing
Globus	R Raheja Group-Real Estate	8	N/A	8 new stores by 2005
Pantaloon	Pantaloon Retail	12	N/A	4 stores by 2005. Venturing into home improvement retailing
Ebony	DS Group	9	N/A	2 more stores by 2005

Source: PricewaterhouseCoopers

Specialty stores

With increased importance of personality and its spill over into possessions, consumers are looking for variety to establish/suit their identity. This has led to the emergence of an important sector in India. In this format the large conventional players are Crossword (for music and books) and RPG's Musicworld. Specialty stores are developing into specialty malls, such as Senior Builder's Auto mall (automobile products), Gold Souk (jewellery mall), Interiorz (home solutions) by Aeren Group, a wedding mall (one-stop shop for all wedding-related needs) and Deepak Group's Ishanya (for interior and exterior home products) etc.

E-commerce

Internet usage is estimated to be at more than 25 million in 2005. PC penetration is rapidly picking up in India. Currently three million units are sold per annum; this is expected to reach eight million in the next two years.

E-commerce is said to have exceeded USD126 million during 2004-05. The travelling and ticketing sector generated the most number of transactions. Government organisations like the Indian railways and organised e-retailers such as Fabmall.com, IndianPlaza.com, Indiatimes.com, Bazee.com and Rediff.com dominate the online marketplaces.

M&A activity

In the first part of 2005, mergers and acquisitions (M&A) in India touched USD5.4 billion, which is 3% of the total Asia Pacific deal value. The M&A activity in the first part of the year is higher than the corresponding previous period, with 167 deals completed at the beginning of June 2005, compared to 137 deals in the first half of 2004.

The outbound M&A trend has gained increased momentum this year. There were 31 outbound M&A transactions in the first half of 2005 compared to 38 in the whole of 2004. This trend is predicted to continue with companies from varied industries looking at increasing their sales from overseas operations. Dabur India, an FMCG company, is on the lookout for opportunities in the

US health supplement market as part of its entry strategy for North America. The company has identified 20 focus countries where it is evaluating the need to establish manufacturing facilities or marketing presence.

Indian M&A deals are making their way to the top deals table. The UB-Shaw Wallace deal in 2005, is listed amongst the top-10 deals in the consumer/healthcare sector in Asia Pacific. Consequently, UB Group has become the second largest liquor company in the world. The other major deal was the Videocon Group and Thomson SA deal, where Videocon acquired a 100% stake in Thomson SA's colour picture tubes (CPTs) manufacturing business for USD282 million, making it one of the largest players in the global CPT business.

M&A activity

Year	Acquiring company	Acquiree/JV company/target	Nature of business
2004	Benetton	DCM	Apparel
2004	Sterling group	Barista (Turner Morrison's residual stake)	Coffee bars
2004	Sterling group	Barista (Tata Coffee's stake)	Coffee bars
2004	ICICI Ventures	Subhiksha	Discount retailing
2004	e-bay	Bazee.com	e-retailing
2004	Trinethra	Fabmall	Online/Discount retailing
2005	UB	Shaw Wallace	Liquor
2005	K Raheja group	ICICI/Crossword	Bookstore retail
2005	Dabur	Balsara	CPG
2005	Videocon	Thomson SA	Colour picture tube
		Electrolux Kelvinator Ltd	Consumer durables
2005	Trent(Tata Group)	Landmark	Bookstore retail

Source: Industry estimate, PwC Analysis

RETAIL & CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

Certain specific characteristics of the Indian economy directly impact the retail and consumer sector (besides the consumer demographics and regulations) and present themselves as key challenges for marketers. These, if handled appropriately, can facilitate unleashing the vast potential of the Indian market

Challenges

Urban rural divide

The rural Indian consumer (comprising almost 70% of the population) is economically, socially and psychologically very different from his/her urban counterpart, which is reflected in the differences in purchasing preferences. Brand penetration strategies are distinct in the rural sector as they vary on cultural, society, caste, community and hierarchical factors. This automatically changes how consumer product goods (CPG) companies do business. The Indian market is dominated by small “mom and pop” retail outlets, estimated at approximately 12 million outlets (of which about 65% are in rural areas). Accessing these outlets is one of the biggest challenges facing CPG companies.

Strong local companies

Possibly due to the virtually closed nature of the economy until the late 1980s, India saw the emergence of strong domestic companies and brands. In fact, these companies proved to be tough competition for the multinationals operating in India, due to the scalability of their models. This forced the multinationals to adopt innovative strategies for success in the Indian market. Local competition and regional players managed to hold market share in respective markets in large categories like detergents and toothpaste.

Cultural preferences and tastes distinct from the global economy

Given the strong and diverse cultures in India, several multinational firms have developed customised products specifically for the Indian market. For instance, McDonalds redesigned its menu to include vegetarian and non-beef burgers in India. Similarly, Domino's and Pizza Hut have introduced pizzas with Indian cuisine toppings. Over one third of Pizza Hut's revenue in India is attributable to such additions. In the cosmetics category, Hindustan Levers offers soaps based on sandalwood and Ayurvedic ingredients.

Fluctuations in commodity prices/oil costs

Some of the key raw materials are dependent on commodity market fluctuations, which results in aggressive pricing strategies. Due to prevalent high oil prices, the Indian economy also has to balance the inflationary costs. In certain segments, companies have been trying to backward integrate their procurements from agricultural producers.

Cold chain distribution at a nascent stage

Several companies are hesitating to launch their international brands or are customising their product offering, given the limited cold chain distribution network in India. This is evident in the lack of organised growth in branded and packaged fresh fruits, vegetable, milk and confectionary businesses. However, rapid growth of the modern trade sector and expected entry of global food retailers in the near future will have significant positive effect in upgrading and modernising India's food chain.

High real estate costs

Traditionally, real estate costs in India have been high, especially when considered as a percentage to sales levels. Further, procuring property in the central/downtown areas for large format stores has been difficult due to the fragmented private holdings of land and infrequent auctioning of government-owned vacant lands. These factors have stymied the growth of large-sized retail stores. During the past few years, however, there has been some rationalisation of real estate prices. Significant growth in the suburbs of metropolitan cities has presented retailers with the opportunity to expand in these locations.

Opportunities

Low penetration of modern trade

Perhaps the biggest opportunity for new entrants into India's modern trade sector (including global retailers) is that only 3% of the total retail market is organised, providing ample space and time to experiment with innovative formats and value propositions. This coupled with the huge size of the market provides enough room for many new players to co-exist in the near future.

Urban and rural spending

Urban growth in the CPG sector is showing a spread over a diverse basket of goods, such as cheap mobiles, cheap financed consumer goods and new entertainment options. Moreover, for most of the international brands second tier semi-urban cities, like Nagpur, Surat, Vadodara, Ahmedabad, are showing maximum growth potential.

The Indian rural market contributes significantly to the consuming class (41% of India's middle class and 58% of the total disposable income), and therefore offers a huge opportunity that CPG companies cannot afford to ignore. Rural spending and demand is also fuelled by good-heavy rains monsoons in the country, which has been the case the past few seasons. CPG majors are looking at higher rural penetration where growth is high. The foresighted marketers who believe in the potential of rural markets are trading off the distribution cost with incremental market penetration.

Winning brands

The various strategies adopted by corporates that are continuously trying to achieve winning brands in the CPG sectors can be summed up as:

- Focus on market and rural penetration, leveraging alternative media and awareness campaigns like ITC, Hindustan Lever Limited, Nirma and Coca Cola.
- Focus on growing consumption in markets, creating buying power by giving easy access to credit and increasing income generation.
- Focus on market-based pricing strategies and looking at competition, as in the case of Arvind Brands, which introduced a competitively priced jeans wear brand called Ruf & Tuf.
- Focus on non-core business and, if not, sustainable easy exit options.
- Rationalisation of brands portfolio and focusing on power brands as adopted by Hindustan Lever.
- Focus on brand innovation and technology investment for R&D for products aimed at the poor.
- Focus on alternative distribution models (exclusive stores, direct marketing and e-commerce) to have the largest market reach.

Supply chain effectiveness

A large number of CPG players are making huge investments in end-to-end connectivity to reduce inventory, as most of their operations are scattered. On the sourcing side, this is being extended right up to the third-party manufacturers, and on the distribution side these are being extended to the secondary segment. In the agri-foods business the linkages are being extended to

the agricultural farmers. For instance, the beer industry is encouraging farmers in Haryana to produce barley. As rural penetration levels are rising, the margins of rural consumer products contribute to adverse product mixes if large volumes are not achieved.

Indian modern trade companies are also playing a vital role in modernising the supply chain. Foodworld (the erstwhile joint venture between RPG and Dairy Farm International) and Metro are among those who are pioneering supply-chain efficiency in India. For instance, about 40% of Foodworld's merchandise is sourced from about 500 local small scale industries, providing vital market access to these vendors and assuring quality to Foodworld, which otherwise would have been almost impossible in the context of India's fragmented distribution system.

Tax & regulatory

The Indian Government is at an advanced stage in making amendments to the current policy regarding FDI in retail, which bans global retailers from operating in India. Although the new policy is not yet in place, a host of leading global retailers have started preliminary groundwork to evaluate an Indian market entry. The entry of global retail companies would have a huge impact on the Indian industry, expanding the overall market size of modern trade, modernising the supply chain, bringing in global best practices, providing wider choice to consumers and generating new employment.

With the introduction of VAT in 21 states, most of the corporates have reengineered their businesses to open new units in the states of Uttaranchal and Himachal Pradesh, where fiscal incentives can be leveraged. There are also a number of companies optimising sourcing strategies due to changes in state sales tax laws, by moving from purchase of finished goods to cost-plus models.

Another issue being debated in India is the Intellectual Property Rights for Patents, Copyrights and Trademarks, and its legal protection system in India. Most of the CPG industries feel the need for a tighter clamp down on manufacturers in the grey market on such IPR infringements.

Sourcing from India

For some years now, multinational retailers, like Wal-Mart, GAP, Carrefour, Li & Fung, JCPenney, Tesco and Nike, have sourced apparel and lifestyle products from India. Some of these retailers are looking at India to increase their sourcing commitments and are moving from third-party sourcing offices to establishing their wholly owned/managed sourcing or buying offices.

A recent trend in India is that large CPG players like Kellogg's and Sara Lee plan to make India an export hub

for their operations. Sara Lee plans to set up a wholly owned subsidiary that will source, manufacture and export undergarments, casual wear and footwear from India.

Franchise system

Franchising is a popular global market entry/expansion route adopted by many global retail and food services brands. Franchised operations are becoming more popular in geographically vast and culturally diverse nations like India, as franchising helps to overcome the difficulties posed by having a chain of company owned outlets. Moreover, India is one of the most entrepreneurial nations. The Indian middle class is changing its tastes, preferences and lifestyle, and thus a large number of Indians are ready to lap up good international products and services. Thus, successful global franchise corporations have a bright future here.

The franchising industry in India enjoyed a boost during the 1990s when the economy was opened up. Since, then, sales from franchised businesses have grown at an average rate of 20-30%. According to the Franchising Association of India (FAI), franchising is a USD2.2 billion industry and is growing rapidly. There are nearly 700 franchise systems already operating in the country.

A large number of domestic franchisors have made their mark through the franchising model (e.g., Aptech, NIIT, and Kidzee in the field of computer education, Café Coffee Day in food and beverages, and Apollo in health and medicare). International franchising in India is one of the most exciting areas in the franchise industry. Global franchise organisations such as Pizza Hut, Marks & Spencer, McDonald's, Subway, HP, Holiday Inn, Medicine Shoppe, Marrybrown, Domino's, Gold's Gym, Kodak, Taco Bell, Mail Boxes Etc., Kentucky Fried Chicken and Tommy Hilfiger are fast becoming household names, and are bullish on the potential of franchising in India.

Emerging trends

Aggressive pricing strategies

The pricing of international products in India in relation to the per capita GDP is much higher compared with other countries in the Asia Pacific region. These imbalances will be rectified significantly as penetration of consumer goods increases on one side and share of modern trade increases on the other. At the same time, this highlights the opportunity for retailers developing high quality private labels at reasonable cost.

Product variants/Innovation and branding strategies

Food products showing sluggish growth are going through the regime of relaunches, innovative packaging,

sales promotions, price discounts and freebies. Some companies are also foraying into new products, with the introduction of sachet packs or paisa packs for the rural basket of consumers. Product awareness is a key driver in most such initiatives. Companies are looking at product variants to cater to regional tastes. A number of companies are investing in research and development to supplement established product portfolios.

New competition

New entries into the sector (including global players) will fuel competition and price wars. This is evident in the personal care segments and the biscuit industry. Regional players are also holding their own against international brands due to the scalability of their operations.

Market growth

Profit margins of the leading CPG companies that participated in the recent shampoos and detergents sector price wars have been eroded. Future growth will be fuelled by new scenarios, such as youth, rural penetration, higher spending powers and growth of states, which offer a positive prospect for the stronger FMCG companies to garner greater market share. Further, improved infrastructure will imply better connectivity for the rural areas and therefore prospects of increased incomes and exposure, which in turn implies a promising future for CPG companies.

Cost pressures/third party sourcing

Further, liberalization of policies for currently reserved dereservation sectors, introduction of VAT and tax incentives in backward states will fuel higher profitability. Tax incentives in backward areas have helped Colgate, Britannia, Dabur, Godrej, Hindustan Lever and Marico set up manufacturing facilities in Uttaranchal and Himachal Pradesh. Third party sourcing is a commonly adopted practice in India and allows flexibility in production, inventory planning and control of labour costs, besides offering a logistics solution of catering to a large market.

Exports of India-grown CPG companies

Homegrown CPG majors facing sluggish domestic demand are looking at markets in the SAARC region and Middle East, including Bangladesh, Nepal and Pakistan, which have a high growth potential due to the large Indian population living in the region, similarity of lifestyle and consumption habits. Some leading companies have taken their brands outside by exporting or establishing subsidiaries. These include Godrej, Marico, and Dabur, to name a few. Others are establishing a strong export market playing on the natural and Ayurvedic platforms.