

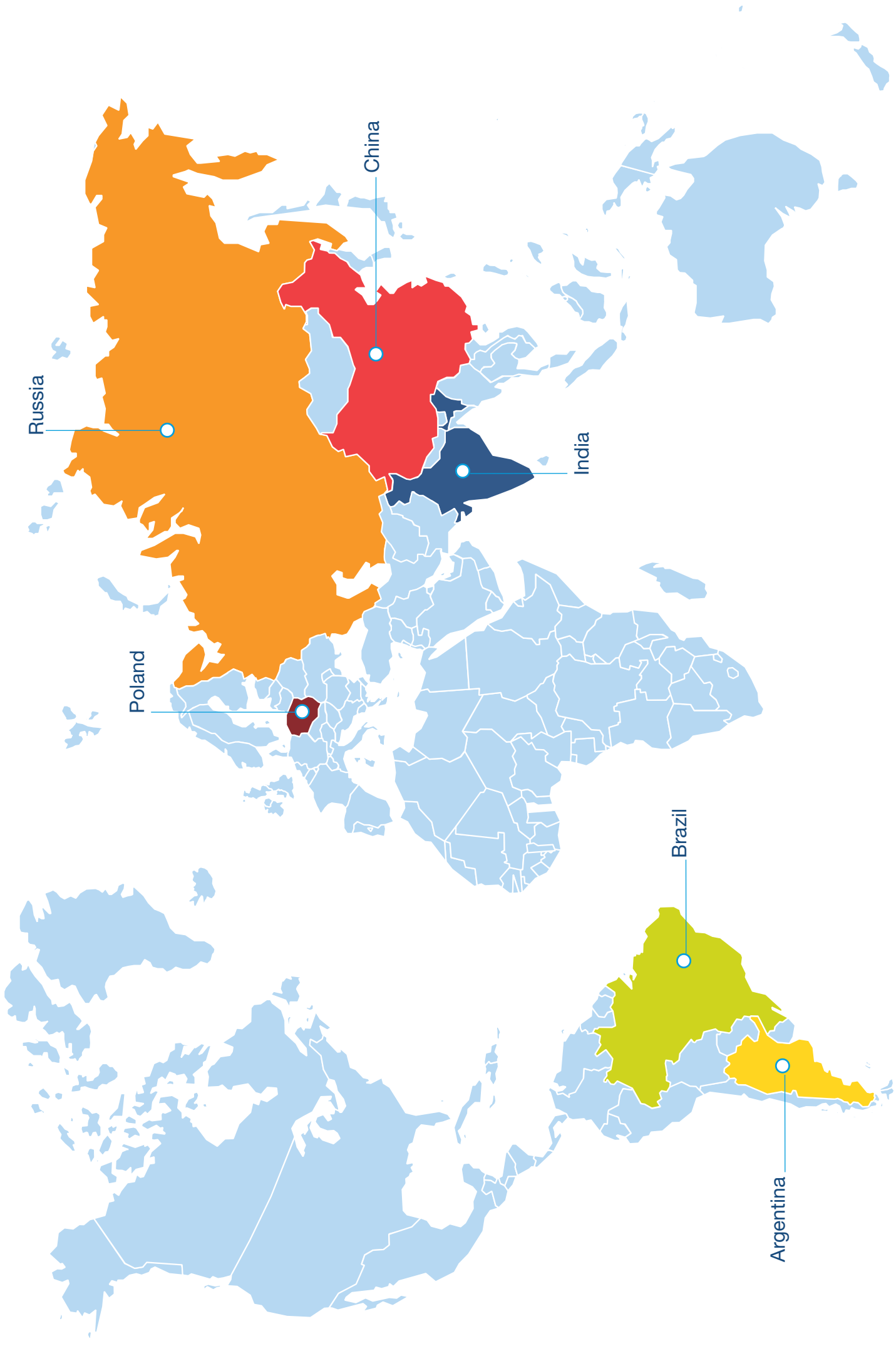
From São Paulo to Shanghai

New consumer dynamics: the impact on modern retailing*
2006/2007 • 5th Edition



*connectedthinking

PRICEWATERHOUSECOOPERS 



Russia

China

India

Poland

Brazil

Argentina



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It is with great pleasure that we publish the 5th edition of PricewaterhouseCoopers' annual regional research project. This on-going thought leadership study has analysed over the years the different and changing investment challenges and opportunities for companies in the retail and consumer sector in transitional economies.

Each year, we determine the scope of our analysis and emphasise regions according to the angle we want to explore, as can be seen from the following list of past editions:

- *Retail & Consumer: From New Delhi to New Zealand* (2002/2003)
- *Retail & Consumer: Winning Strategies in Russia and Central & Eastern Europe* (2003/2004)
- *Retail & Consumer: Growth Dynamics from New Delhi to New Zealand* (2003/2004)
- *From Beijing to Budapest: New Retail & Consumer Growth Dynamics in the Transitional Economies* (2004/2005)
- *From Beijing to Budapest: Winning Brands, Winning Formats* (2005/2006)

This year, we have focussed on three main regions in the developing world – Asia, Eastern Europe and South America. We addressed two major economies from each continent, which include the four BRIC (Brazil, Russia, India and China) countries as well as Argentina and Poland. Therefore, this year's study is at once broader and deeper.

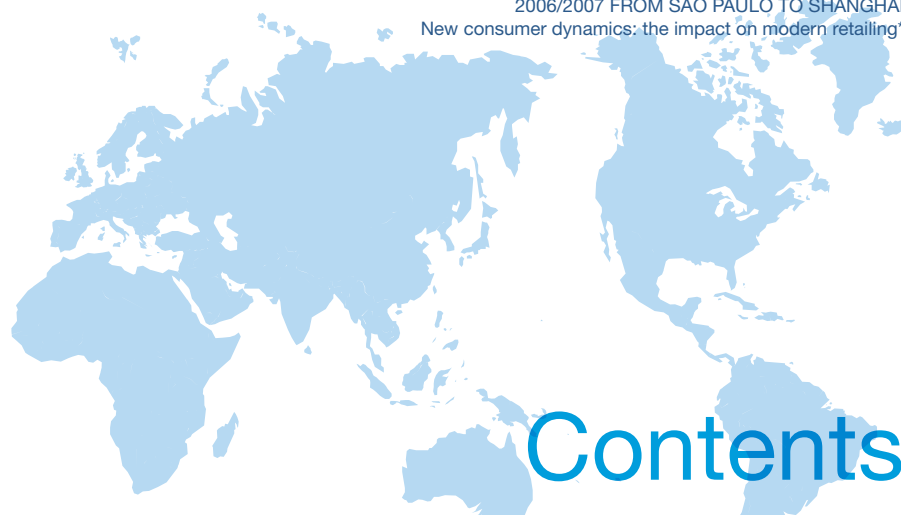
As usual, the goal of the study is to provide a general picture of the economic, social and cultural environment in which business investors have to operate, as well as to indicate the major consumer trends and identify the relevant challenges and opportunities for companies in the retail and consumer goods sector¹. This year, each country report includes [case studies](#) which highlight [practical examples from both multinational and regional players](#).

This year, the United Nations estimates that half of the world's population will live in cities by 2007; as such, particular emphasis has been placed on the urban-rural divide and its impact on investment strategies. Argentina, Brazil and Russia have predominantly urban populations, whereas in China, India and Poland, the majority of the population still lives in rural areas or small regional towns. This two-speed consumer model is producing new investment opportunities through a gradually emerging rural renaissance in certain regions.

We are proud to engage once again in the continuing success of our annual study – and to be into our 5th year of publication! The huge potential for investors in the regions covered this year jumps out of the pages of the six country reports, which are available on our website at www.pwc.com/growth or in the pocket CD enclosed with each Executive Summary. In the meantime, this Executive Summary should give you a taste of the range of information provided by our experienced professionals around the world.

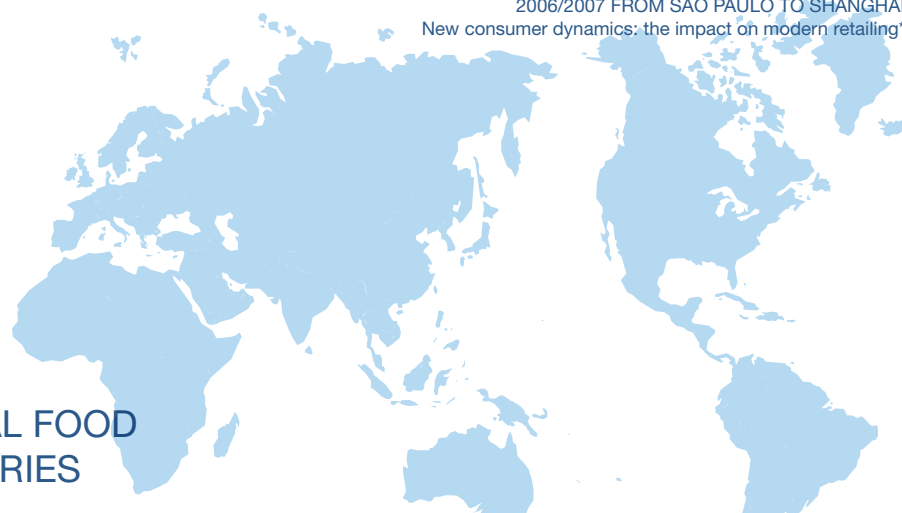
Carrie Yu
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¹ The sector comprises (i) distribution activities (wholesalers, distributors, retailers), (ii) suppliers of consumer packaged goods (food and non-food), and multinationals, regional and local players from both activities (i) and (ii)



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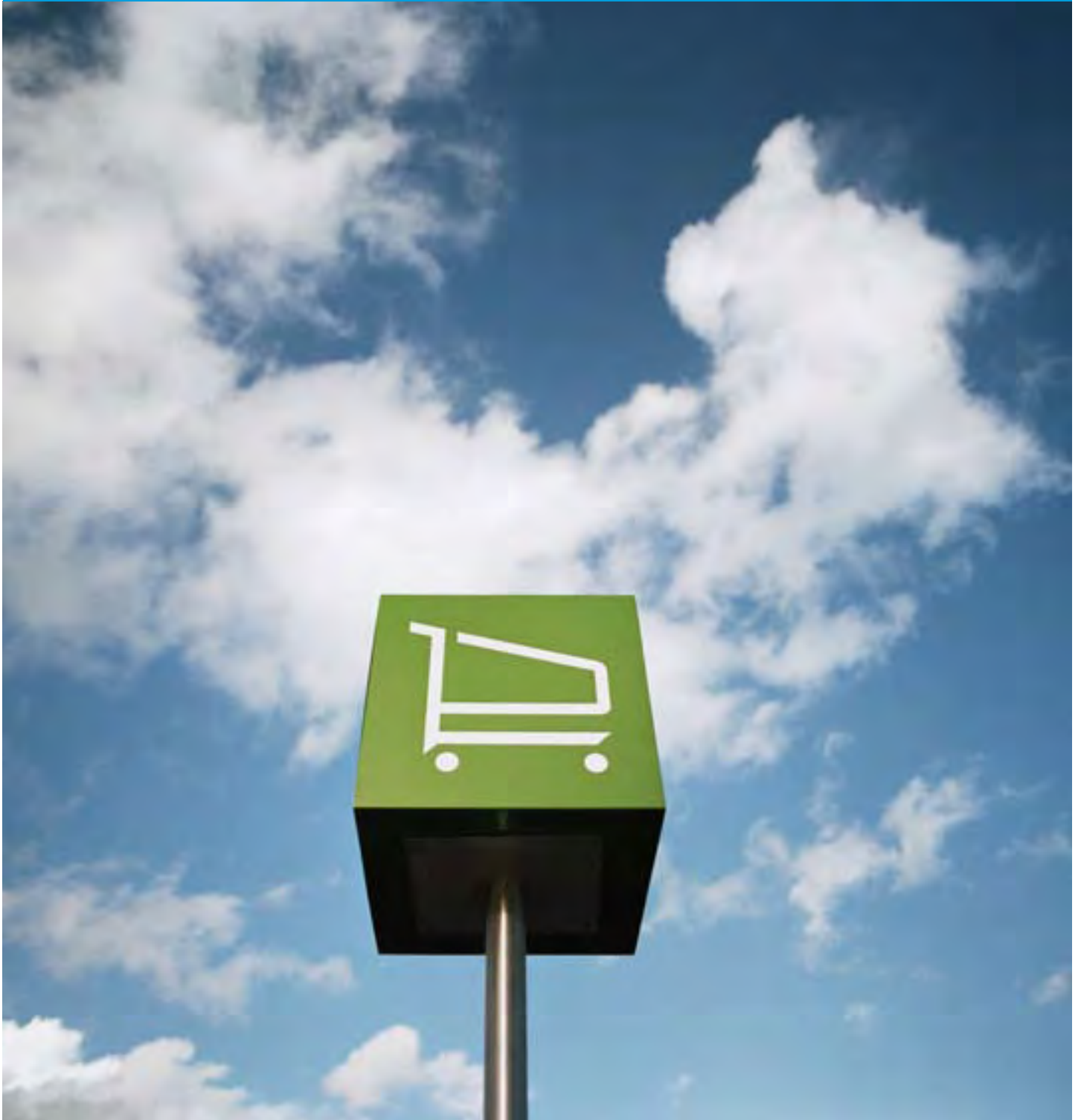


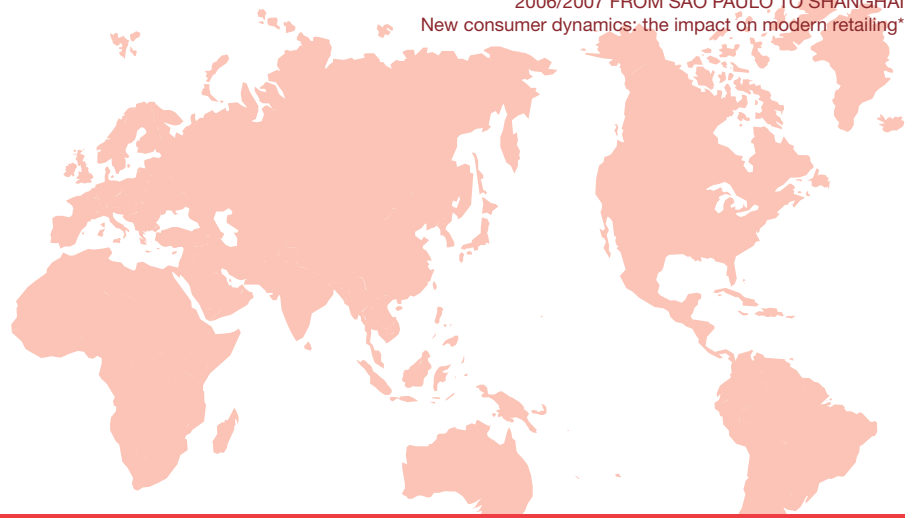
PRESENCE OF MULTINATIONAL FOOD RETAILERS IN THE SIX COUNTRIES

	Argentina	Brazil	China	India	Poland	Russia	Total
AEON (Japan)			X				1
AHOLD (The Netherlands)					X		1
AUCHAN (France)			X		X	X	3
AVA (Germany)						X	1
CARREFOUR (France)	X	X	X		X		4
CASINO (France)	X	X					2
DAIRY FARM INTERNATIONAL (Hong Kong)			X	X			2
FAMILY MART (Japan)			X				1
INTERMARCHE (France)					X		1
JERONIMO MARTINS (Portugal)					X		1
LECLERC (France)					X		1
LIDL & SCHWARZ (Germany)					X		1
MAKRO (The Netherlands)	X	X	X				3
METRO (Germany)			X	X	X	X	4
MIGROS TÜRK (Turkey)						X	1
REWE (Germany)					X	X	2
SEVEN & i Holdings (Japan)			X				1
SHOPRITE (South Africa)				X			1
SPAR (The Netherlands)			X	X	X	X	4
TENGELMANN (Germany)					X	X	2
TESCO (UK)			X		X		2
WAL-MART (USA)	X	X	X				3
TOTAL SCOPE	4	4	11	4	12	7	42

Source: PricewaterhouseCoopers – Vigie August 2006

Executive Summary





SETTING THE SCENE FOR RETAIL AND CONSUMER BUSINESS INVESTORS



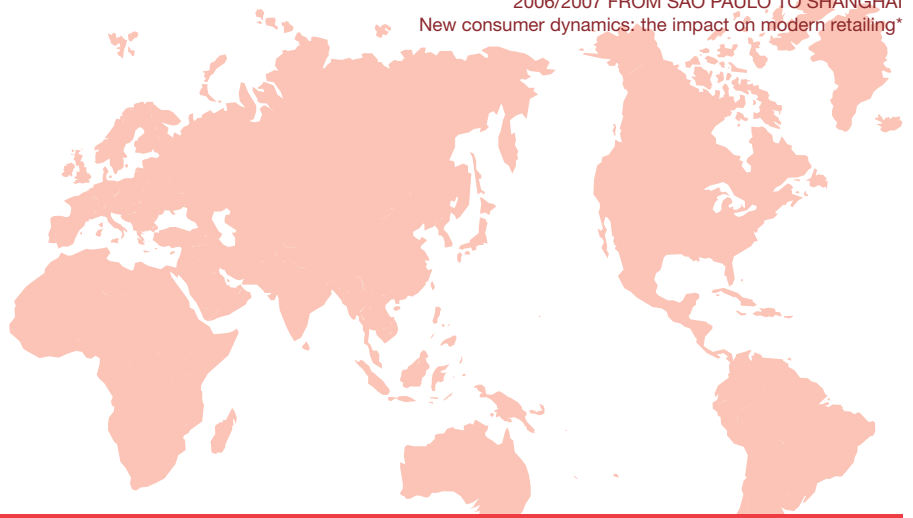
This year's study highlights a major contrast in GDP growth across the six countries covered. GDP appears to be set to accelerate in three out of the six countries: China, Brazil and Poland, over the period 2006 to 2008. China's economy was expected to cool down somewhat, but the continued growth that was achieved in the first half of 2006 points to sustained high growth in the months to come. Indeed, for the second time since April, Chinese authorities pushed up interest rates in August in the hope of slowing down investment. Brazil's GDP started picking up in 2004 after several years of erratic growth and it now looks as if it should be sustained at about 3.5% over the next three years.

Key economic growth indicators

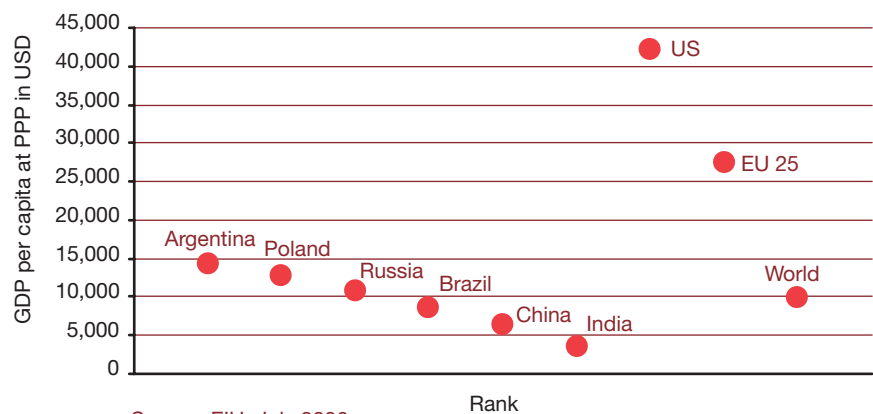
Country	GDP growth 2005 (%)	CPI 2005 (%)	Unemployment rate 2005 (%)
China	10.2	1.8	9.0
India	8.5	4.2	8.9
Russia	6.4	12.7	7.6
Poland	3.4	2.1	18.2
Argentina	9.2	9.6	11.6
Brazil	2.3	6.9	9.8
USA	3.5	3.4	5.1
EU 25	1.6	2.1	9.3
World	3.4	3.7	N/A

Source: EIU, July 2006

In both India and Russia, growth is slowing. India's GDP will move from a high of over 8% in 2004 to 2005 to around 7% for 2006 through 2008, and Russia's will evolve from over 7% in 2003 to 2004, to around 6% and lower for the three years to come. Rates in Russia should, however, be sustained and perhaps improved by higher oil revenues and increases in personal incomes and household consumption. The economic outlook in Argentina, after three years of high growth at around 9%, is tempered for the near future. According to official statistics, growth rates are expected to decline slightly in 2006 to approximately 8% and substantially in 2007 to 4.2%.



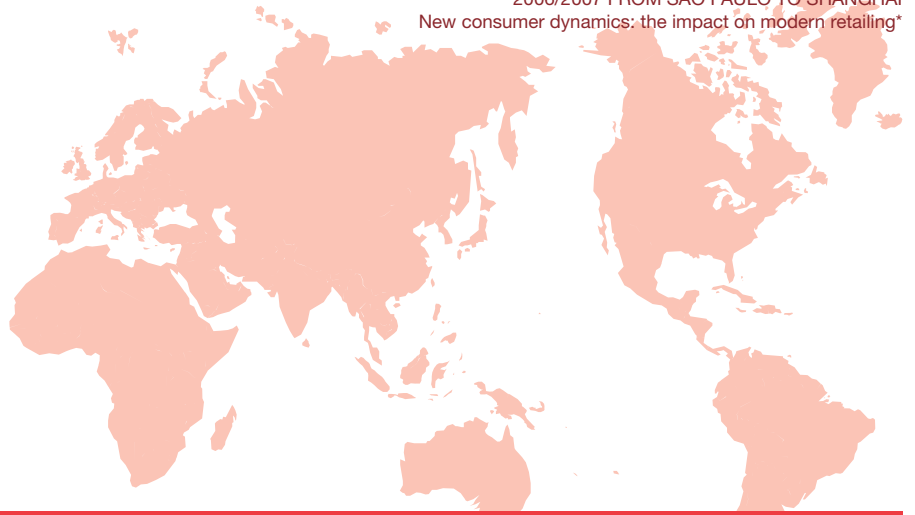
GDP per capita at Purchasing Power Parity in 2005 (USD)



Source: EIU, July 2006

As far as **Consumer Price Index (CPI)** is concerned, the majority of countries covered by this report appear to be taking the right measures and successfully controlling their inflation rates. The exceptions are Russia and Argentina, with an average 10% forecast for 2006. Argentina is still licking its wounds after the economic crisis in 2001, which has had a long-lasting effect on consumption. Drastic rate hikes in 2003, 2004 and 2005 have helped decrease inflation from a high of 22% in 2002 to an estimated 10% this year, according to government and local economist projections. Inflation should be contained at this level over the next three years, with the government pushing price control agreements within different industries in order to control price increases across the board.

Unemployment is a challenge in all profiled countries, from the lowest rate in Russia at 7.6% of the population in 2005 to the highest in Poland at 15.7%, according to official statistics. In Poland, unemployment of the young – those between 15 and 24 years of age – has reached 34.7% by local estimate. But over the last two years, these figures have been improving, mainly due to workers' migration into other EU states following accession. This trend is becoming a major issue for transitional economies such as Poland, where trained and skilled workers are lured away to countries in which they can find more lucrative jobs and better lifestyles. For example, since 2004, 264,000 Polish workers have emigrated to Great Britain alone. Foreign investors in the retail and consumer sector are being hit by this new development in the Polish labour market. According to official figures, the Chinese, Indian and Russian economies show signs of decreasing unemployment over the next couple of years. In China and India in particular, economies are developing faster than they can educate their populations, and increasingly, there is a **lack of skilled workers**.



Although China and India are still attracting increased **Foreign Direct Investment (FDI)**, and FDI in Argentina has been stable during the last two years, the other countries covered by the report all show a **slight decline** in foreign investment. In Brazil, food and beverage represented the most attractive sector for foreign investment.

The general increase in the price of raw materials worldwide and its impact on costs throughout the supply chain is undoubtedly one of the reasons contributing to this general slowdown. Many retail and consumer goods investors are also now into the second or third phases of their development into foreign territories. So after what has often been the breakneck speed of the first phases of expansion into foreign markets to enjoy first-mover advantage, this could be a time for taking stock, revising operational and marketing strategies, before moving on to the next stages of development.

Entry into, or the prospect of entry into the **World Trade Organization (WTO)**, is having a beneficial impact on foreign investors. China has liberalised its rules substantially since 2001. Russia is negotiating entry at the moment. In Hong Kong, a special trade agreement, the Closer Economic Partnership Arrangement (CEPA), will facilitate access to mainland China for companies using Hong Kong as their launching pad.

The other **positive sides of government intervention** for the retail and consumer goods sector include: Brazil's welcome political and tax reforms after the elections of October 2006; the Chinese government's encouragement of the development of a rural retail network; and India's recent move to open the market to single-brand retailers, which will encourage further market entry. In China, direct selling is now permitted within the framework of new regulations; restrictions on franchising have been removed and an action plan has been launched in a bid to enhance the protection of intellectual property. The protection of intellectual property rights is also the subject of pending legislation in Poland.

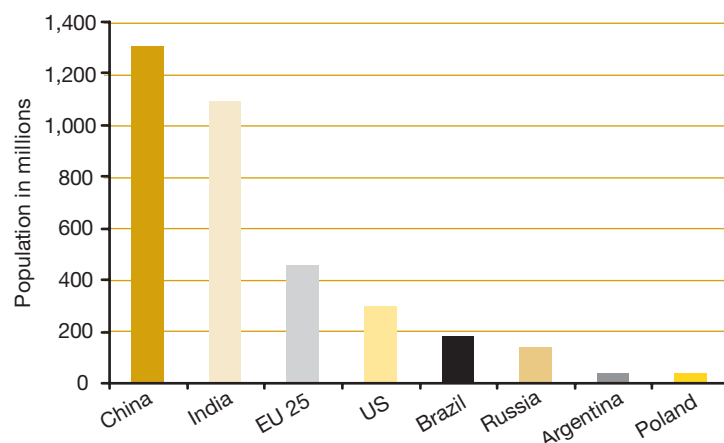
SERVING A RAPIDLY CHANGING CONSUMER SOCIETY

The findings in all the markets covered highlight stark contrasts between urban and rural consumers, the young and the old, the rising middle classes and the much poorer populations who have been left out of the new economic growth spiral – in both urban and rural areas – as indeed have whole regions within countries.

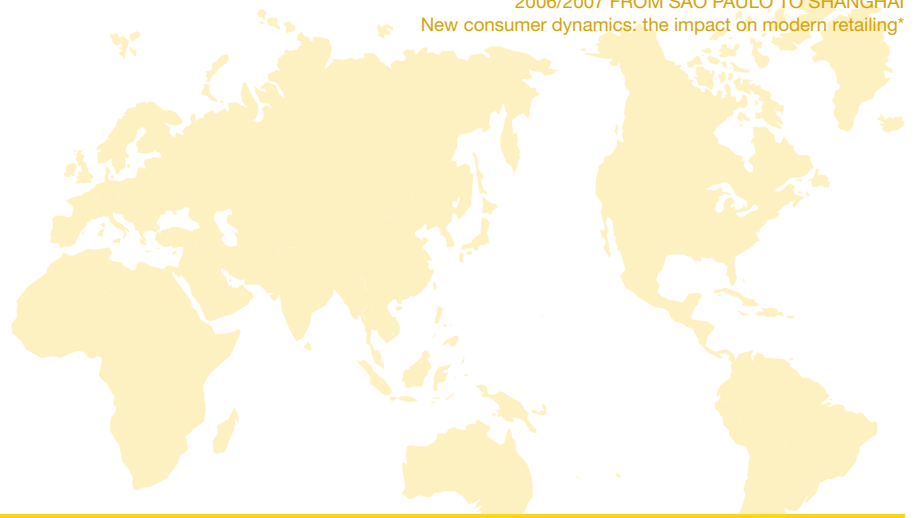
DEMOGRAPHICS

Populations are growing in China, Brazil, India and Argentina, whereas Poland and Russia both have declining populations. With an increase of 15 million people against China's 7 million, India's population is growing twice as fast as China's. India will therefore overtake China as the world's largest population faster than expected – probably by 2030. India can also boast the youngest population in the world. **Young people represent a huge opportunity – and challenge – for developing countries.** Education is a priority that governments cannot afford to neglect if their countries are to capitalise on this potential workforce, which can drive up living standards and consumption levels and reduce existing income disparities. These economies would be well advised to adopt inclusive policies to engage, and even centre, the new young in their economic development.

Population by country in 2005



Source: EIU, July 2006



CONSUMER DYNAMICS

Emerging consumption patterns will be driven by the following consumer components:

- The middle class
- The new rich and the upwardly mobile young adult
- The working woman

The middle class

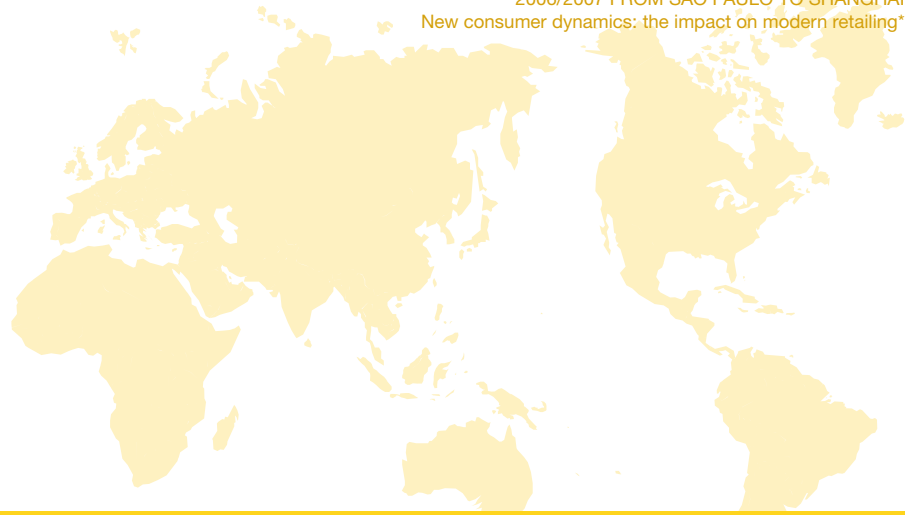
A fast-emerging **middle class** is driving consumption patterns everywhere. The criteria used for designating the middle class varies so much from one country to another that it is difficult to give one definition of the average income brackets of this population segment. But these mainly urban dwellers are contributing to the statistics that show that less is being spent on food and groceries and more on equipping their homes. The success of home furnishings, DIY and consumer electronics outlets are all being driven by the middle class.

In addition, the development of credit cards will give a further impetus to middle-class consumption in all the transitional economies. In China, the insurer Ping An has decided to diversify into what it considers to be a very important potential credit market and Wal-Mart is planning to launch its own credit card in partnership with GE Money and Shenzhen Development Bank. The number of cards issued in China has accelerated 13 times to 40 million in the past two years.

The new rich and the upwardly mobile young adult

At the upper end of the middle class, the new rich and the **upwardly mobile young** are driving luxury brands and lifestyle products. In this segment, foreign brands are in big demand and seen as both fashion statements and status symbols.

Many luxury brands are investing in extremely sophisticated flagship stores in the upper-scale malls of transitional economies, as both advertising and sales vehicles for the **new rich**. Indeed in many cities in both Eastern Europe and Asia, the luxury industry is spurring urban renewal. In China, the LVMH group is dispatching architects to work with regional city authorities to explore the architectural potential of future commercial centres. In order to test the waters in cities a little further afield, many big luxury brands have already invested in stores in Hangzhou, a city southwest of Shanghai.



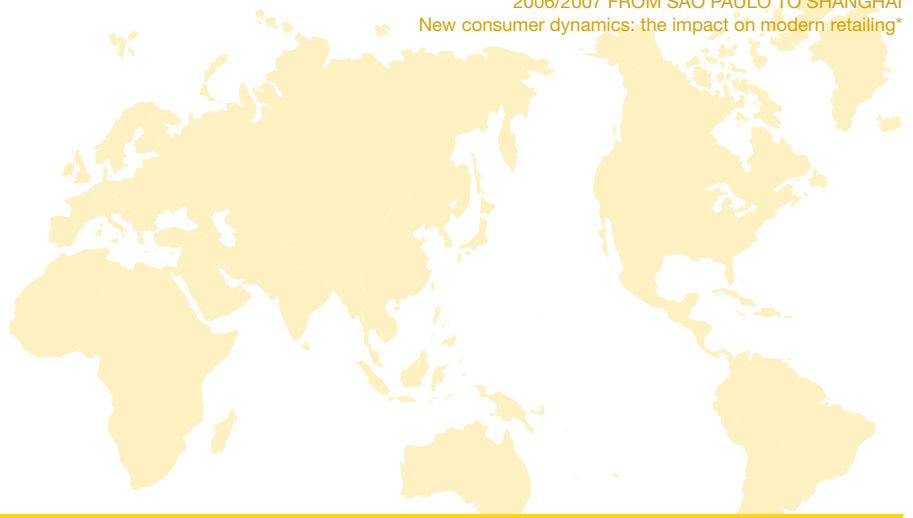
The working woman

The impact of the increasing number of **working women** on consumption trends is of note in the reports from China, Brazil and India. In India, the number of women at work has increased from 22% of the working population in 1991 to 26% in 2001. A study in India notes that urban working women, on an average, spend about 24% of their earnings on enhancing the quality of their own life, as compared with 13% on household purchases. Other areas of expenditure for Indian working women in urban centres include savings/investments (23%), spending on children (13%), purchase of durables (9%), insurance premium (7%) and monthly dues such as electricity and water bills and rent (5%). Working women need packaged, easy-to-use FMCG (Fast Moving Consumer Goods) to facilitate their lives and they also use more HaBA (Health and Beauty Aids) as they spend more time out of the home in a competitive work environment. For example, the Russian cosmetics and personal care market is one of the most rapidly growing in the world, with annual growth rates of around 13%. In Brazil, another promising market for these products, revenues rose by 14.1% in 2005. In general, the two factors that were the main drivers of modern commerce in the West – the working woman and car ownership – will impact the development of retail and consumer in the transitional economies in much the same way.

SERVING A BROAD CONSUMER SPECTRUM: THE DEVELOPMENT OF BRANDS AND MULTI- FORMAT RETAILING

As the amount spent on food diminishes, opportunities for FMCG investment are offered by the development of new distribution channels such as the increasingly popular shopping centres with their restaurants, bars and takeaways. And as the middle class ages in most markets, with the exception of India, consumption trends will include the development of healthcare and pharmaceutical product segments.

Premium and luxury brands are highly popular at the top end of middle class populations. International brands in non-food products, and particularly luxury items such as fashion and consumer electronics, have a big future. For example, according to Merrill Lynch, Chinese customers already account for 11% of the world's luxury industry, and are expected to buy 23% of the industry's output by 2014. The luxury group LVMH's chief executive, Bernard Arnault, says, "For us, China is very similar to what we did in Japan." Global luxury brands are all ensuring that they establish a firm footprint in the Chinese market.



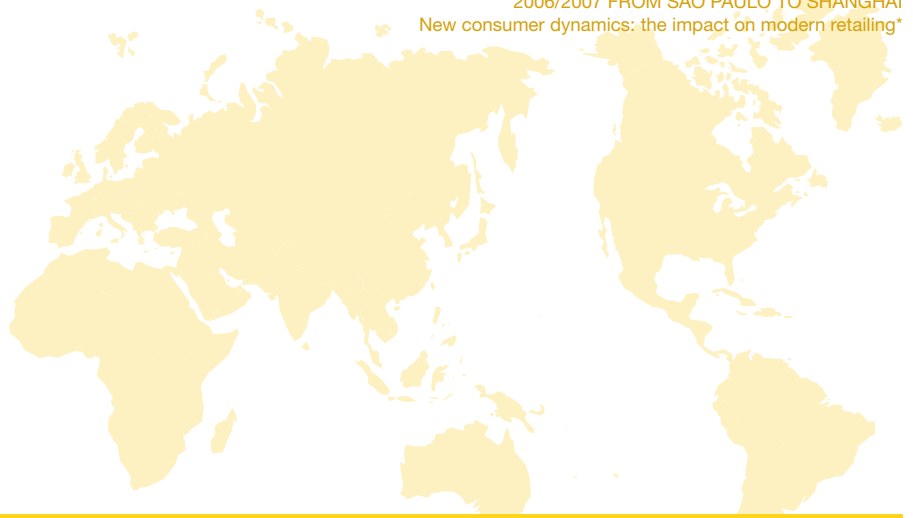
Private label represents a big growth opportunity in most FMCG markets, and these products are being expanded by supermarket chains in Argentina, Brazil and Russia. In Russia, overall market share does not yet exceed 3% for hypermarkets but can reach 10% in discount stores. In Poland the penetration rate is 4% of total market share. The Hong-Kong-based AS Watson chain offers over 1,000 private-label products in China, representing about 20% of its total product offer. In general, private labels are associated with lower prices, which appeal to the price-conscious, lower-income consumer segments.

As far as **retailing** is concerned, this year's report shows that foreign retailers are particularly strong in Argentina, Brazil and Poland whereas their total market share in China, Russia and India is relatively small. Foreign retailers are keenly evaluating the Indian market and identifying partners to forge an alliance within areas currently permitted by regulations. In Argentina, the regional player Cencosud leads the market followed by Carrefour at close range. In Brazil, local CBD enjoys the number one retail slot, with Carrefour and Wal-Mart respectively occupying numbers two and three. In China, the majority of the top 30 retailers are domestic companies, with Carrefour enjoying the top foreign retail slot. French Auchan, German METRO and Turkish Ramenka are the three foreign grocery retailers in the Russian market to date.

But being a foreign retailer does not guarantee success, as can be seen by the departures of Ahold and Sam's club from Argentina, Ahold and Sonae from Brazil, OBI from China, and Casino and Dohle from Poland.

What store formats seem to be doing best in the countries covered by this study? Many retailers are adopting the multi-format approach so as to be able to adapt to the very different shopping patterns that can exist within regions and even within one country.

There appears to be a correlation in trends, with the traditional supermarket often being squeezed between the bigger **hypermarkets** or smaller stores such as the **hard discount**, **convenience store** or traditional store. In general, the discount segment in transitional economies is developed by foreign players, with the exception of Russia, where this market is dominated by domestic operators.



In Poland, both Carrefour and Tesco are adapting to this “smaller is beautiful” trend; Carrefour having opened its first Carrefour Express in June 2006 and Tesco having recently opened its Jedynka outlets. Tesco may introduce its own Tesco Express concept in the future as well. But many supermarkets are also managing to sustain their attractiveness with their relatively large product mix, and smaller size, in other markets. For instance, they are considered the second most dynamically developing format in Poland after discount stores. In China, the supermarket is still the dominant format in food retailing and discount outlets are in the development stage.

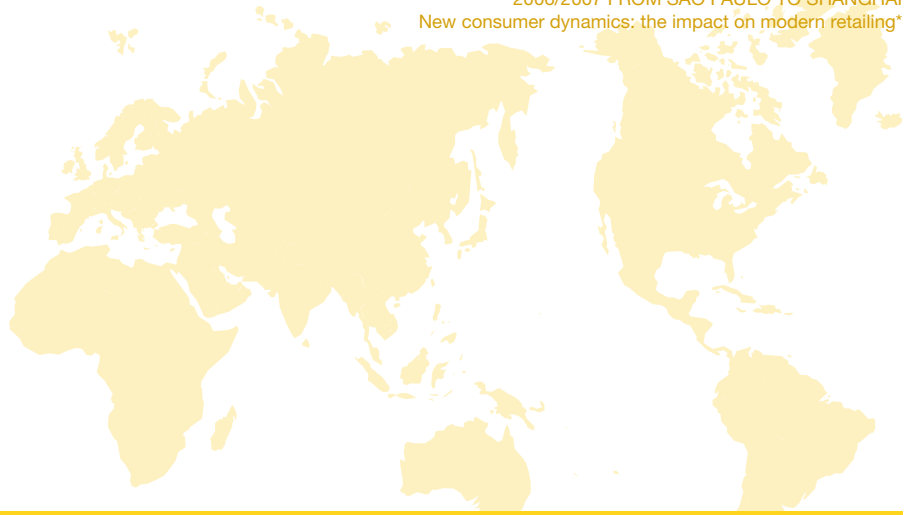
The growing middle class is pushing the development of **speciality stores** everywhere. Outlets for **home furnishings**, **DIY** and **consumer electronics** are all in big and increasing demand. The consumer electronic market is thriving and is often dominated by domestic retail companies. Russia’s DIY sector is enjoying annual growth of 30% to 40% and DIY is also considered one of the fastest developing retail sectors in Poland. The Kingfisher Group, through its subsidiaries Castorama and B&Q as well as Leroy Merlin and OBI, are the main DIY foreign players in transitional markets. IKEA is well established in home furnishings in most of these economies, and Home Depot is to open soon in China.

Shopping centres continue to act as a pivot for modern retail outlets and in particular for stores selling luxury products and brands. At the same time, these malls fulfil a role as leisure centres with restaurants and facilities for entertainment. For example, in Argentina, it is expected that some 30 new commercial centres will open in provincial towns within the next 18 months. In India, the number of malls is expected to rise to 220 by 2007 against the 30 malls in operation in 2003.

Source:
PricewaterhouseCoopers
Brazil Report Case Study,
October 2006

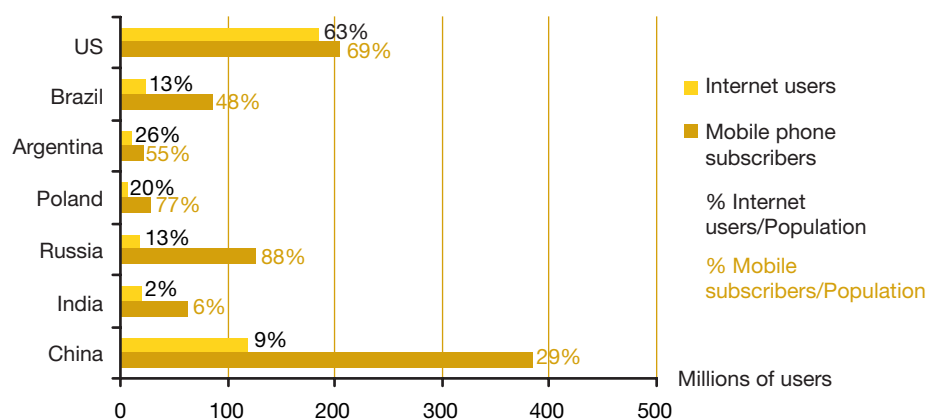
How has Companhia Brasileira de Distribuição (CBD) used multi-format retailing as a strategy for success?

CBD, renowned for one of its brand names, Pão de Açúcar, is the largest retail chain in Brazil. Using an aggressive growth strategy involving numerous acquisitions, CBD has been in the vanguard of many retail trends in Brazil, including the vigorous development of different stores formats in order to serve various consumer opportunities. CBD, which launched the first electronic and delivery supermarket in Brazil in 1995, is now an organisation with 70,000 people, operating hypermarkets, supermarkets, discount stores, department stores, DIY outlets, home appliance stores, consumer electronics stores and an e-commerce channel.



Internet users are increasing everywhere, and although online sales are rising fast, the Internet is not yet a significant channel for shopping. As in more developed countries, it is non-food purchases that are the most popular. In Poland, the sales of Internet shops and auction portals exceeded 1% of total retail sales for the first time in 2005. In China, business-to-consumer transaction volume was RMB5.6 billion (USD8.11 billion) in 2004. With the development of the technology-enabled consumer, Internet and indeed m-shopping (mobile phone shopping) will very much be part of the longer-term future. One of the most important factors behind the growth of e-commerce will be the increasing availability of credit cards. Large populations of young consumers will push these trends forward as fast as they can go. It is estimated that there are now more than 1 billion people with Internet access worldwide, of which 200 million are located in the countries covered by this study.

Number of Internet and mobile phone users and penetration rate†

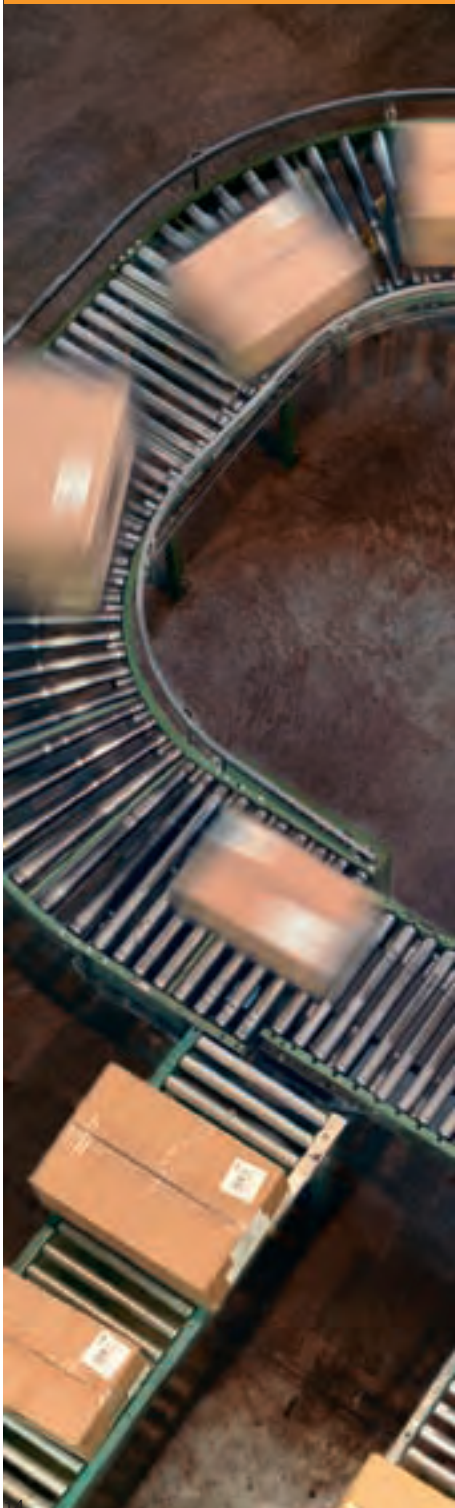


Source: EIU, July 2006

†2005 estimates



STRATEGIC CHALLENGES AND OPPORTUNITIES



The six countries covered by our study all offer big investment opportunities for companies in the retail and consumer sector. The development of all transitional economies is extremely complex, as one part of the population inevitably moves ahead faster than others. This is a challenge because retail and consumer companies are confronted with **extremely diverse markets as far as incomes and lifestyles are concerned** and as the detailed discussion on the rural renaissance below illustrates. In addition, economic success is often simply not followed up fast enough by policies to put in place the modern infrastructures that are paramount to success in today's fast-moving global economy. But constant innovation in tailoring products and advertising to widely differing consumer segments, and the development of know-how on local markets through partnerships with domestic companies, can accelerate successful expansion.

STRATEGIC CHALLENGES AND OPPORTUNITIES

Challenges

- Logistics
- Regulations
- Brand loyalty
- The fight for talent

Opportunities

- Retail and product distribution concepts involving local populations
- Mergers, acquisitions and partnerships
- Rural renaissance and expansion into Tier II and Tier III cities
- Product innovation

Challenges

Logistics

The importance of government investment in infrastructure – everywhere – cannot be stressed enough. It is estimated that, in China, logistics represent 20% of a product's cost compared with 10% in the United States. According to *The Economist*, India needs an additional 2.5% to 3% of GDP annual investment in infrastructure if it is to sustain its current economic growth of



around 8%. Montek Singh Ahluwalia, deputy chairman of India's Planning Commission, says, *"The investment required to upgrade our infrastructure is massive and not all of it can come from the public sector."*

One way of tackling the supply chain problem is to contract out the function to a third party. For instance, Unilever has done so in India, where it has now achieved national reach with more than 20 distribution centres. Given the huge distances involved, Carrefour decided to use local networks for its logistics function in China from the beginning, rather than build its own platforms and systems. The president of Carrefour China, Jean Luc Chéreau, says, *"You have to work with local distributors, and the power in this case belongs to them."* It is estimated that the Chinese market share for **third-party logistic service providers** will grow from the current 3% to 20% by 2010, with a market value of some USD30 billion.

Regulations

Local legislation on size, zoning, property and urban locations are all part of the challenge of operating abroad. With regulations varying greatly from one country to another, government intervention has both positive (see the first section of this Executive Summary) and negative sides.

On the negative side, foreign retailers in Argentina and Poland are still subject to **restrictive store** size. The Indian move to open up the market to foreign single-brand retailers will not help international grocery retailers that are still not allowed to own retail operations. And this is in spite of the fact that it is generally accepted that foreign retailers not only source the vast majority of their products locally – over 90% of local procurement for Wal-Mart in Brazil, Carrefour in China and METRO in India – but also help local producers to export abroad. India is the world's second-largest grower of fruit and vegetables. Foreign food retailers could do a great deal to help modernise India's agricultural sector in which some 30% of produce is lost because of the lack of efficient cold chains, logistics functions and continuing inadequate infrastructure. METRO, the wholesaler that has two distribution centres in India with three more planned, shows just what can be done.



Source:
PricewaterhouseCoopers
India Report Case Study,
October 2006

METRO works with Indian farmers to improve logistics, having:

- Launched a supplier relationship management portal to modernise supply chains.
 - Partnered with the government of Karnataka to improve the infrastructure for fisheries in the state.
 - Launched a pilot project for farmers near Bangalore, providing knowledge and training for local farmers.
 - Initiated several training projects for Indian sheep farmers.
-

Brand loyalty

Building brand loyalty is not easy, above all with grocery goods, in spite of the first loyalty programmes and cards being put in place. In many transitional economies, there is a definite bias in favour of local retailers and local products. In Poland, two-thirds of customers prefer locally manufactured products. International companies need to add real value to their products and differentiate them clearly. **Health and safety considerations** are two product components that favour international brands.

The potential vulnerability of foreign brands is demonstrated by the recent accusations that Coca-Cola and PepsiCo products contained high levels of pesticide residue in India. Local authorities were very quick to jump on this issue and products from these companies were banned in several states.

Counterfeit and fraud are other major problems that international brands have to contend with. In June 2006, the world's biggest mobile phone manufacturer, Nokia, lodged a formal complaint for industrial counterfeit for the first time in China. Governments are beginning to address what is a major global issue. Intellectual property laws are being reviewed in China, Poland and Russia to protect foreign investors. In China, action is also being taken on a business level. *The Financial Times* reports an agreement made by landlords who pledged to suspend or evict tenant retailers found selling counterfeits manufactured by a group of 23 international brands.



The fight for talent

Attracting, training and retaining good staff continues to be a major challenge for foreign investors. This is exacerbated by the fact that in certain countries, for instance China and India, there is an **increasing lack of skilled workers**. Although both these countries produce millions of graduates every year, they are often not immediately employable by multi-nationals as they do not always have the operational skills necessary for corporate management jobs.

This situation is pushing wages up as demand outstrips supply. One of the fundamental problems that many transitional economies have to face up to is that their populations cannot be educated or trained quickly enough to keep up with economic growth. Some **companies are developing their own training facilities** to fill this gap. An example is B&Q, which has set up its own university in China. The company's CEO in China, Steve Gilman, says, *"I could say that talent is among our biggest challenges."* Both B&Q and Carrefour use bonus strategies to motivate and retain good staff. Carrefour set up its China Institute in 2000. If trained staff members leave before their contract expires they have to reimburse their training expenses. In Russia, where the METRO Group has a high demand for qualified staff, the company has initiated a "METRO Education" project. In the context of this plan, the METRO Group will be supporting business schools in more than 14 cities. It will be contributing both learning material and additional training for teachers. In addition, foreign retail and consumer companies also collaborate with local leading universities on specific retail training programmes.

Source:
PricewaterhouseCoopers
Poland Report Case Study,
October 2006

Tesco's talent programme generates employment

- Tesco has created 20,000 new jobs since it entered the Polish market in 1995.
 - 40% of its staff was previously unemployed.
 - 11% are graduates for whom Tesco is their first employer.
 - Tesco offers a comprehensive training programme to help new recruits develop the necessary management skills as fast as possible.
 - Tesco Polska's talent development programme has been so successful that it is being used in the company's operations in other countries, including China, the Czech Republic and the UK.
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Opportunities

Retail and product distribution concepts involving local populations

Retail concepts that demand the involvement of local populations are in favour across the board. **Franchising** is mentioned as an opportunity in the reports from China and India. **Direct selling** and **voluntary chains** also offer employment and training opportunities to locals. In the past couple of years, both SPAR and IGA entered the Chinese market. SPAR is targeting Tier II cities and its first hypermarket, opened in conjunction with a local partner Jia Jia Yue Supermarket, has proved successful. In China, the concept of voluntary chain operations has received official government support and has generated keen interest among independent domestic retail operators. At the same time, the franchising market is growing at 40% per year. In India, Tommy Hilfiger and UK-based Costa Coffee both chose franchising as the mode of entry into the country. As a result of the re-opening of the Chinese market to direct sales – albeit within a tight legal framework – Avon hired over 114,000 sales representatives this summer, highlighting the promise that direct selling holds in the Chinese market.

In 2005, Unilever launched its “Project Shakti” in India to build a product distribution network in rural areas, through the co-opting of 200,000 women entrepreneurs. The project is based on self-help groups which can borrow small loans of, for instance, USD250 from a micro-credit company. Thus members buy stocks for a network of direct-to-home distribution. At the moment, there are about 13,000 Shakti women distributing products in 50,000 villages. The goal is to recruit some 100,000 women entrepreneurs, covering a network of 500,000 villages – representing some 400 million customers.

Mergers, acquisitions and partnerships

Strategies for market penetration and growth, including mergers, acquisitions or partnerships, are on the rise in all these transitional markets either **to facilitate entry into a new market or to drive growth**. The total number of deals was up in Argentina, Brazil and Russia, which saw a wave of joint ventures with foreign investors in 2005. In Russia, M&A activity increased by 65% over 2004, and in its consumer market the highest level of activity took place in the brewery and retail sectors. India had a record year for financial transactions, with 625 deals – both incoming and outgoing – valued at USD16.3 billion, representing 200% growth over the previous year. In Brazil, where the food and beverage and retail sectors accounted for 70% of total transactions in 2005, there have already been 54 deals in the first half of 2006, compared with 56 transactions for the whole of 2004.



Consolidation is already taking place in a number of markets as smaller local players join together to build up critical mass and international firms buy up locals to establish trading posts in more far-flung regions.

In a move to gain critical mass, the Russian market retail leader, Pyaterochka, merged with competitor Perekrestok this year. And in India, the country's biggest retailer, Pantaloon Retail, set up strategic alliances with Planet Sports, Liberty Shoes and Unitech Enterprises to expand its range of products. In India, established retailers like Pantaloon will be competing against new large corporate entrants such as Reliance, the petrochemical and textiles giant, and Bharti Enterprises, a major player in the telecom industry.

On the foreign front, Danone, furthering its strategy to partner with local companies, acquired 22.2% of the number one Chinese fruit juice producer, Hui Yuan, in July 2006. And proposed takeovers, such as SEB's acquisition of Supor and Candy's purchase of Jinling, are also set to increase. SEB sees China's Supor as a low-cost producer for the sale of its fast-moving household electrical products worldwide. At the time of writing, these proposals are still subject to official approval.

Concentration is a general trend and PricewaterhouseCoopers forecasts, for example, that the number of large retailers in operation in Poland will drop from the current number of twenty to between five and six by 2010.

The rural renaissance and expansion into Tier II and Tier III cities

United Nations figures show that half the world's population will live in cities in 2007. And one out of three city dwellers – 1 billion people – will be classified as part of the urban poor segment living in insalubrious housing conditions. Indeed, the rapid urbanisation of populations in the transitional economies is creating a substantial problem: assimilation. But it appears that India and China are attempting to come to grips with what can be termed as Asia's growing **inequality challenge** and contain the too-rapid influx of millions to cities that simply cannot guarantee minimal living conditions. Both China and India are addressing income disparities in general and the development of their rural poor populations by encouraging a **rural renaissance** in particular.

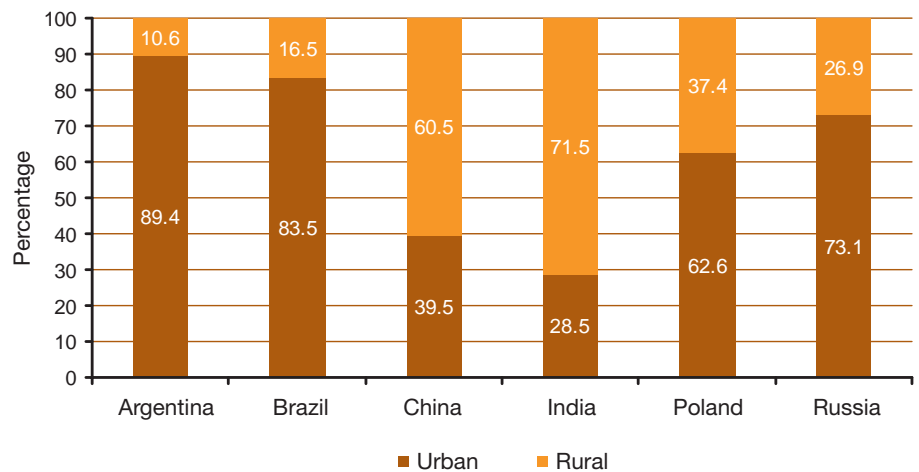
All countries in the study have in common a major income disparity between the haves and the have-nots. Rural populations are the poorest, but the massive migration of workers to the biggest cities, for example, in Brazil or China, has created an equally massive urban poor. According to the reports from Argentina and India, over 30% of their populations live under the



poverty level. It is through their investments, which will contribute to improved lifestyles, that retail and consumer companies will be tackling what C.K. Prahalad, the renowned Indian academic, describes as “the fortune at the bottom of the pyramid”.

There is an important split between the urban-rural population of the countries covered in the study. Argentina, Brazil and Russia have predominantly urban populations, whereas in China, India and Poland, the majority of the population still lives in rural areas or small regional towns.

Urban vs. rural split in percentage of total population in 2004



Source: EIU, July 2006

In China, the government is giving incentives to develop rural areas by lowering taxes and investing in education and health. In March 2006, the Chinese central government announced a series of measures to build a “new socialist countryside” over the next five years, including a new rural retail network.

Support from local authorities will pave the way for retailers to the hitherto untapped rural market. Encouragement will be given to retailers that take over or cooperate with existing rural stores by means of franchising or voluntary chain operations.

The incomes of Chinese rural populations are increasing through the money sent back to them by their families working in large cities – or when these workers return home. At the same time, Chinese companies are beginning to set up new factories in regional, under-developed areas in order to benefit from a more stable labour force. For example, businessmen from Wenzhou,



an eastcoast city in China, are starting to build large manufacturing facilities in Chongqing, a fast growing city some 2,000 km west of Shanghai. If this area takes off, the development could reflect a **shift in the country's economic geography**. Instead of workers migrating to big urban centres, factories will move to where workers live.

By the same token, in India, large software companies such as Satyam Computer Services are decentralising offshored IT services out of big cities to more distant regions and villages. As a **lack of skilled workers in big cities starts to make itself felt – with a corresponding rise in wages** – it makes sense to decentralise to smaller cities where the new economic prosperity enjoyed by the biggest urban areas has not yet permeated down. The Indian state-run telecom operator, Bharat Sanchar Nigam, has plans to bring 25 million new mobile connections to villages over the next three years. Manoj Kohli, the president of Bharti, India's leading telecoms carrier, says, *"It's very clear that, of the 700 million living in villages, 400 million can afford a mobile phone, and the other 300 million may be able to three to five years from now."*

In all the countries covered by the study, foreign and local retail chains are stepping up their investment in Tier II and III cities and less-developed regions, as the Tier I cities become saturated.

In India, both Globus and Pantaloon have already begun building a retail presence in Tier III cities before many other retailers have finalised their Tier II operations. In China, the home improvement chain B&Q was encouraged by the government, which contributed financial assistance, to expand into western regions of the country. The **emergence of regional players**, including foreigners, which go immediately for regional development will be among future development trends. In Argentina, Wal-Mart and Carrefour are both vigorously developing their operations in the interior regions of the country.

As a rural renaissance emerges, formats adapted to these less-sophisticated populations are being designed. In India, ITC is experimenting with a **rural hypermarket** through its "Choupal Sagar" format, which combines grain procurement and a storage centre with the mall. The underlying premise of this model is to capitalise on the farmers' visits to wholesale markets to sell their produce by offering them a range of products and services. Another example is DCM Shriram Consolidates, which is launching **"one-stop shops"** for farmers.

Adapting products, packaging and advertising to rural markets is a strategic requirement. The contrast between the Cartier watches and the CHANEL handbags so sought after by the new rich, could not be greater when compared with the basic necessities such as toothpaste, detergents or mosquito repellents which are needed by rural populations. The question of



product packaging is highly significant in rural areas: the shampoo market took off in India when the product was packaged in individual sachets rather than in bottles which were too expensive. Another example is afforded by Unilever, which launched its Lifebuoy soap in India in 2000. The product lost money for about a year, but took off when the company reviewed the product's quality and perfume and underlined its health and hygiene benefits for children. The price was increased by 20%, and sales increased by 15% per year.

Product innovation

Research and development are crucial to innovative and successful product development in all regions. Offers must be constantly adapted and fine-tuned to the very differing needs of specific age groups and geographical regions and the on-going change in consumption patterns. Global suppliers are increasingly **establishing research and development centres** in China. Johnson & Johnson recently set up a consumer goods R&D and innovation centre in Shanghai. P&G pays particular attention to developing cultural empathy in its advertising campaigns for different markets, and in China it has used traditional medicinal remedies to create new toothpaste flavours for its Crest brand. For Danone, the development of research centres in China is very much part of its strategy for expansion in Asia. The company has recently opened a centre for fresh dairy products in Shanghai. It has three others. One is devoted to the biscuit business, developing products aimed at consumers in China, India, Indonesia and Malaysia. The other two are dedicated to beverages for the Chinese market. It has 150 researchers, product developers and engineers working on product innovation in China.

Source:
PricewaterhouseCoopers
China Report Case Study,
October 2006

P&G in the Chinese market: growth through product innovation and adaptation

- P&G sells products in more than 500 cities in the country.
 - The company established a lead position in the shampoo market before broadening its portfolio to other products.
 - On average, P&G introduces one new brand of products in the Chinese market every six months.
 - The company's innovation model, "Connect + Develop", taps into the creative thinking of not only its own researchers, but a wide spectrum of individuals outside the organisation.
-



CONCLUSION: CORRELATION AND CONTRASTS



There is a strong correlation across the countries studied this year as far as **favoured formats** are concerned: hypermarkets at one end of the size spectrum, discounts and convenience stores at the other. Consumer dynamics are also very similar, with a growing middle class, a “new rich” class and an important segment of upwardly mobile young adults. International **brands** are popular in the upper and middle classes, for whom fashion items and consumer electronics function as status symbols. FMCG brands find it more difficult to penetrate certain markets where there is still a preference for local brands in groceries. This underwrites the major potential of **private-label** products as a solution for the very price-conscious grocery shopper.

What jumps out of this study are: the contrasts thrown up by the urban-rural divide; the widening gap between skilled and unskilled workers; and the polarisation of the formats and products needed by highly differentiated consumer segments at each end of the social spectrum.

But, as it is now recognised, the retail and consumer sector can do a great deal to accelerate the **improvement of lifestyles** through modernising supply chains, employing and training workers and selling high-quality products in the countries in which they invest. In China and India, tackling the left-outs in rural areas opens up new areas of opportunity for business as governments seek to spread the benefits of economic development more equitably.

Other changes, such as the increase in the number of **working women**, the rise in the number of **credit cards** and a potential explosion in **car ownership** are all factors that will be pushing consumption to much higher levels that will greatly favour the retail and consumer goods sector's expansion.

Who will be the **future winners** in the transitional economies: foreign retail and FMCG companies or locals? The answer is: both. International companies are driving the modernisation of retail and consumer goods development and new concepts, formats and products. Innovation, flexibility and continual adaptation to specific markets are the rules of the game. Indeed, global players are becoming increasingly local-minded or “glocal”, as local players become more westernised in their operational approach. Therefore, competition will be increasingly tough. Neither locals nor foreign investors will dominate in the long run. But what is certain that is critical mass is essential for success: BIG will win.

Argentina



Area ('000 sq km)¹: 2,800
(US 9,600 – EU25 3,981 – World 133,700)

Capital²: Buenos Aires
(Number of inhabitants: 13.5 million)

Population (million): 39
(US 296 – EU25 459 – World 6,000)

Median age³: 30 years

Nominal GDP (USD billion): 183.3
(US 12,487 – EU25 13,447 – World 44,183)

Nominal GDP (USD billion at PPP): 559.1
(US 12,487 – EU25 12,657 – World 59,763)

GDP per head (USD at PPP): 14,307.8
(US 42,129 – EU25 27,538 – World 9,962)

Currency³: Argentine peso (ARS)
(USD1 = ARS2.9)

Languages³: Spanish

Main religions³: Roman Catholic

Government type³: Republic

Sources: () Economic Intelligence Unit 2006 data,
(¹) World Bank 2005, (²) City Population, including Great
Buenos Aires area, (³) CIA Fact book



Argentina

ECONOMIC OVERVIEW

A high potential for the South American continent

Argentina has an important role within the South American continent, due to the size and natural richness of its territory, its open market economy, its highly qualified population and its market size. It is the 2nd economic market in South America. Argentina should attract more and more companies interested in the South American continent, either as a market entry point or as a part of a broader commercial expansion plan.

GDP AND CPI

GDP and CPI

	2002	2003	2004	2005
GDP growth (%)	-10.9	8.8	9.0	9.2
CPI (%)	25.9	13.4	4.4	9.6

Source: EIU, July 2006

In 2001, Argentina experienced one of the worst economic crises in its recent history. Political and social instability, the significant devaluation of the Peso and default of sovereign debt caused a collapse which undermined Argentina's economic variables. 2002 saw the economy shrink by 10.9%, with inflation hitting a peak of 40.9% according to official statistics. The social impact of the crisis was huge, leaving over 50% of Argentines below the official poverty line and well over 20% unemployed. But the inflation was controlled and the country managed to return to fragile growth in late 2002.

The path to recovery started in 2003 and the last three years have seen average GDP increases of around 9% per annum, bypassing the pre-crisis peak of 1998. In January 2006, Argentina paid off its debt obligations, amounting to SDR6.7 billion (USD9.7 billion), with the International Monetary Fund by using reserves of the Central Bank. As of January 2006, Central Bank reserves stood at USD18.5 billion and went up to more than USD27 billion during August. Having showed primary fiscal surpluses during fiscal 2003, 2004 and 2005, Argentina has already indicated a surplus of close to 4.91% of GDP for the first quarter of 2006¹.

1 Ministry of Economy



Argentina

Consumer price index has decreased since 2002 but doubled since 2004. In order to contain 2006 inflation levels, the Argentine Government is vigorously seeking to further develop price control agreements with industries. Despite these pressures, CPI index increased 5.8% during the first semester of 2006, and the government expects it to reach a 10% ratio by the end of the year.

The Argentine Government still needs to undertake economic actions, such as the reform of the financial and banking system, the increase in utility services tariffs and softening the distortion in relative prices, in order to return to sustainable growth.

UNEMPLOYMENT

A continuous decrease in unemployment is expected

Unemployment

	2002	2003	2004	2005
Unemployment rate (%)	22.5	17.3	13.6	11.6

Source: EIU, July 2006

Unemployment decreased from 22.5% in 2002 to 11.6% in 2005. Employment growth was driven by the manufacturing and construction industries between 2002 and 2004. During 2005, employment increased in all sectors of the economy. The majority of local companies expect to hire more people overall, with minor dismissals in the short term².

ECONOMIC FORECAST

A tempered economic outlook

Key economic forecasts

	2006	2007	2008
GDP growth (%)	6.8	4.2	3.4
CPI (%)	12.5	10.6	6.9
Unemployment rate (%)	11.1	11.0	10.7

Source: EIU, July 2006

For 2007 and 2008, GDP is still expected to grow but at a lower level and a continuous decrease in unemployment and CPI is predicted.



Argentina

REGULATORY ENVIRONMENT

A complex regulatory environment

FOREIGN DIRECT INVESTMENT

Positive climate for Foreign Direct Investment

FDI

	2002	2003	2004	2005
FDI (ARS bn)	6.6	4.8	12.5	12.2
FDI (USD bn)	2.1	1.7	4.3	4.2

Source: EIU, July 2006

Foreign direct investment is not restricted. Remittances of dividends abroad are also not prohibited. Companies are allowed to transfer monetary funds and/or pay services, for example, royalties, outside Argentina, on a monthly basis, provided that the amounts are equal to or lower than USD2 million. Any amounts in excess of this figure require prior authorisations.

Also, since 2005, the Argentine Government has imposed certain restrictions. For example, foreign investors are obliged to maintain the principal amount invested in the country for a certain period of time before it can be remitted abroad. Financial loans must also meet certain immobilisation requirements.

PROPERTY / REAL ESTATE REGULATIONS

Leasing regulations

Leasing regulations are far more complex than in other countries worldwide. Regulations generally limit rental increases and evictions of tenants. In addition, Argentine laws governing leases state that agreements must be for a minimum term of three years for retail property (except in the case of stands and/or spaces for special exhibitions) and that lease terms may not exceed ten years, except for leases that include a purchase option.

Store openings

The Argentine retail and real estate industries are subject to extensive building and zoning regulations by various federal, state and municipal authorities. These regulations affect land acquisition, development and construction activities, including the size of selling space that can be opened in certain locations and sometimes require a market and environmental impact research report.



Argentina

Development activities are subject to risks relating to the inability to obtain, or delays in obtaining all necessary zoning, environmental, land-use, development, building, occupancy and other required governmental permits and authorisations. In addition, government licenses are required for the operation of retail channels and customary business licenses are required by local governmental authorities.

It is important to point out that, with the exception of very few jurisdictions, retailers are allowed to operate stores/shopping malls 365 days, including national holidays.

OTHER REGULATIONS

Competition law
Commercial Practices Code
(CPC)

The CPC (put into force at the end of the 90s) regulates commercial agreements between retailers and suppliers. It includes provisions for equal treatment under similar circumstances, procedures for debits, credits and rejection of merchandise, use of supplier brand names and product images, implementation of joint logistics and administrative efficiency programmes and interruption or termination of commercial relationships.

Consumer Defence Law (CDL)

The CDL regulates the nature of the information to be given to consumers as well as consumers' rights such as health protection, terms of sale, product warranties, forms of sale (mail and/or on credit etc.), abusive and/or legally ineffective clauses and responsibility for damages, among other issues.

Defence of Competition
Law (DCL)

Acts and behaviour related to the production or trade of goods and services which may limit, restrict or distort competition or access to markets or constitute abuse of a dominant position in a market, in such a manner which may result in damage to the general economic interest are prohibited and penalised.

If a merger or acquisition of business units or interests take place and the aggregate revenue for the country obtained by companies involved exceeds two hundred million pesos (approximately USD65 million), the transactions giving rise to such revenue must be notified to the Judging Board for the Defence of Competition for examination, either prior to, or during the week after the execution of the agreement, the publication of the acquisition or exchange offer or the acquisition of a controlling share. Upon notification, the Judging Board is expected to consider its approval in a short period of time. Lately, certain transactions have experienced significant delays in completing the approval process due to administrative reasons, difficulties in obtaining



Argentina

the proper number of members to form a quorum at the Judging Board (5 members) and/or legal actions started by persons supposedly affected by the proposed transaction.

Law on Fair Trading

This law governs the manner in which merchandise is identified, products are packaged and the information that packaging must contain. It also regulates the manner and type of information to be communicated to consumers by means of advertising, sweepstakes and/or other forms of promotional activities.

Taxation

At the national level, taxes are administered by the Federal Public Revenue Administration. Provincial and municipal taxes are levied and collected under powers derived from the applicable local regulations and governments.

Income Tax

Argentine legal entities and residents pay tax on total income from both Argentine and foreign sources, being able to claim as a tax credit any similar taxes actually paid abroad. Tax rate for corporations is currently at 35%.

Argentina has signed tax treaties with different countries, such as the Netherlands, France, Germany, Italy, Spain and the United Kingdom.

Minimum Presumed Income Tax (MPIT)

Local companies are subject to MPIT, which is assessed at a rate of 1% on the tax value of the company's assets at the end of each fiscal year. The income tax corresponding to the same fiscal year may be recognised as a payment on account of this tax. Excess MPIT over income tax has to be paid and may be carried forward and applied as a payment on account of the income tax determined for any of the next ten fiscal years.

An additional annual tax is levied on the equity of a domestic company if its shares belong to a foreign entity. The applicable rate is 0.5%.

VAT

The general rate of 21% is applied on the sales value of most products and services. This tax is also applicable to imports. Exports are VAT exempt. In addition, some specific goods and services are exempted (for example, bread, water and milk) and others are taxed at a lower 10.5% rate.



Argentina



Excise Taxes

This tax is levied on sales of a wide variety of items like tobacco, wines, soft drinks, lubricants, cosmetics, perfumes, jewellery, among others. The basis of assessment and rates vary with each item. Rates vary between 8% and 20%, although exceptions exist like cigarettes (60%).

Turnover Tax

This tax is levied at provincial jurisdiction level on the gross revenues generated from activities carried out within each jurisdiction. Many consumer goods companies with industrial activities are tax exempted. The rate for consumer goods applicable to rest of CPG (Consumer Packaged Goods) companies is 1.5% in Buenos Aires Province and 3% in the City of Buenos Aires. Average rates for wholesale and retail activities in most jurisdictions are around 3%.

Tax on Financial Transactions

Amounts credited or debited on bank accounts are subject to this tax at a general rate of 0.6%. Certain other financial transactions affected without using bank accounts are taxed at a rate of 1.2%.

Inspection, Safety and Hygiene Rates

These are rates which the municipalities charge for services they render or can potentially render to business entities within their jurisdictions. They vary from one municipality to another and depend on the type of activity. These rates usually generate strong negotiation between retail and consumer companies and municipalities due to the high level of charges the latter try to impose.

Foreign Trade

One of the country's policies is to increase exports through incentives in order to help overcome its balance of payment difficulties.

Imports

The level of import duties currently ranges between 0-35% – taxable basis is Cost Insurance Freight (CIF) – except in cases where a specific minimum duty is applied or which involve merchandise with a specific treatment.

In addition to customs duties, imports are also subject to a so-called "statistical rate" (maximum of USD500 per shipment), VAT at a standard rate of 21% plus a further VAT collection (up to 20%). Some goods are also subject to excise taxes. Withholdings of turnover tax (up to 11%), VAT and income tax are usual for imports.



Argentina

Exports

Since 1991 Argentina is a full member of the Mercado Común del Sur (MERCOSUR). MERCOSUR is the common market formed by Argentina, Brazil, Paraguay and Uruguay as full members (and Chile, Bolivia and Venezuela as associate members) created with a commitment to gradually eliminate barriers on exchange of goods and services between these countries. Noteworthy reductions have already been made and most of the goods originating from member countries are not levied with custom tariffs.

In the case of export transactions, goods are valued based on Free On Board clause.

Definitive exports of goods outside MERCOSUR are subject to export duties. The rates vary from 5% to 20% depending on the tariff code of the merchandise.

Following are some examples of the most important promotional customs regimes applicable to export operations:

- **Draw-back:** under this mechanism, it is possible to obtain total or partial restitution of taxes paid on imports of materials that will be used to produce goods that will in turn be marketed at foreign locations.
- **Rebate:** this benefit permits total or partial restitution of amounts paid for domestic taxes on goods exported for consumption on an onerous basis or services provided in connection with these goods. This regime is compatible with the draw-back regime.

It is now compulsory to bring any foreign currency received for the sales of Argentine products into Argentina for negotiation.



Argentina

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

**POPULATION
EVOLUTION**
*Slowing population
growth*

Population

	2002	2003	2004	2005
Population (m)	37.8	38.2	38.6	39.1

Source: EIU, July 2006

The growth rate of the Argentine population is expected to fall gradually. This is due to the drop in the birth rate, which is partially offset by a drop in the rate of mortality. This moderate demographic growth, together with the vast size of the country, leads to a population density of less than 20 inhabitants per square kilometre³.

**POPULATION BY
AGE GROUP**
*An economically active
population*

Age profile

% of total population	1999	2004	2009 (f)	Trend
0 – 14 years	27.2	26.0	24.4	↓
15 – 64 years	62.5	63.6	64.8	↑
Over 65 years	10.3	10.4	10.8	↑

Source: EIU, July 2006

Population growth trends also explain the decrease in the relative population under 15 years of age and the increase in the population over 65 years of age⁴. Currently, 46% of the population is economically active while the adult illiteracy rate is set at 2.6%⁵.

3 Book issued by Latin American economic investigation foundation (FIEL), "Planning the future: Argentinean families and their decisions on consumption, saving and human resources investment"

4 Instituto Nacional de Estadística y Censos (INDEC), Demographic projections and estimations report. Argentina. 1950-2015

5 World Development indicators (World Bank)/INDEC



Argentina

URBANISATION OF THE POPULATION

A largely urban but geographically polarised demographic

Urban/Rural split

% of total population	1999	2004	2009 (f)
Urban	88.1	89.4	91.2
Rural	12.0	10.6	8.8

Source: EIU, July 2006

33.8% of the population falls under the poverty line (measured as of the second half of 2005). This population is mainly located in the North-East (54%) and North-West (48%) regions of the country. In the Province of Buenos Aires 30.9% of the population live under the poverty line⁶.

INCOME/BUYING POWER

Rising incomes and consumer confidence

Monthly average (ARS)	Income	Income growth	Expenditure	Expenditure growth
2002	806	N/A	272	N/A
2003	828	2.7	403	48.2
2004	1,032	24.6	471	16.9
2005	1,286	24.6	567	20.4

Source : ACNielsen: Master sample AC Nielsen – 1596 houses (December – February 2005)

Consumption levels decreased significantly during 2001 and 2002, not only due to the severe economic crisis but also due to consumer anxiety about future developments of economic crisis.

However, this trend was reversed over 2003, when consumer expenditure increased 48%, partly in response to rising inflation. Salaries have begun to rise to reflect the effect of inflation and new wage increases introduced during 2006 may impact directly on consumption and saving levels.

Today, there is a favourable macroeconomic environment for Argentine consumers, since the local economy is growing faster than the regional average and consumers have an optimistic outlook⁷. Indeed, average monthly expenditure over 2004-05 increased by nearly 20%, from 471ARS to 567ARS and this trend is set to grow in coming years⁸.

6 INDEC

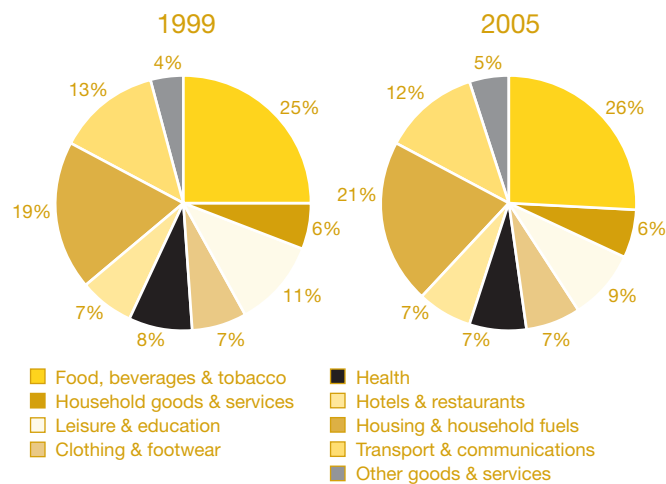
7 Source: AC Nielsen, 2006

8 Source: AC Nielsen, 2005



Argentina

Average household spending patterns



Source: EIU, July 2006

This table clearly shows that by 2005, Argentine consumption patterns had returned to pre-recession patterns. Argentine consumers recovered their historical purchasing behaviour in less than 3 years. Consumption has recovered by 15% in all areas since the 2001 crisis, even for non-basic food items such as frozen food, desserts, chocolates and cookies⁹. The basic household basket now represents lower share of Argentine expenditure. In the low-income bracket, the share of expenses on the essential basket dropped from 59% last year to 57% in 2006. Similarly for the middle-income bracket, basic expenses in 2005 represented 44% of total income against 38% in 2006¹⁰.

In terms of total sales since 2001, revenue for basic categories of food, beverage and cleaning products increased 99% as a result of an increase in prices. This recovery in prices has generated a slowing down of consumption level in terms of volume in recent months¹¹.

Food consumption increased 9% in 2005. Cosmetics products showed a 19% increase. Cleaning products increased only 5% because certain manufacturers fraction products in smaller quantities. Beverage consumption levels increased 20% due to the launch of new products, such as flavoured waters and returnable containers¹².

9,11,12 Source: AC Nielsen, 2005

10 Source: AC Nielsen, 2006



Argentina

The categories with the greatest growth of consumption in 2005 were: liqueurs, cookies, cereals and instant coffee, and those with the largest increase in sales value were liqueurs, powdered milk and instant coffee¹³.

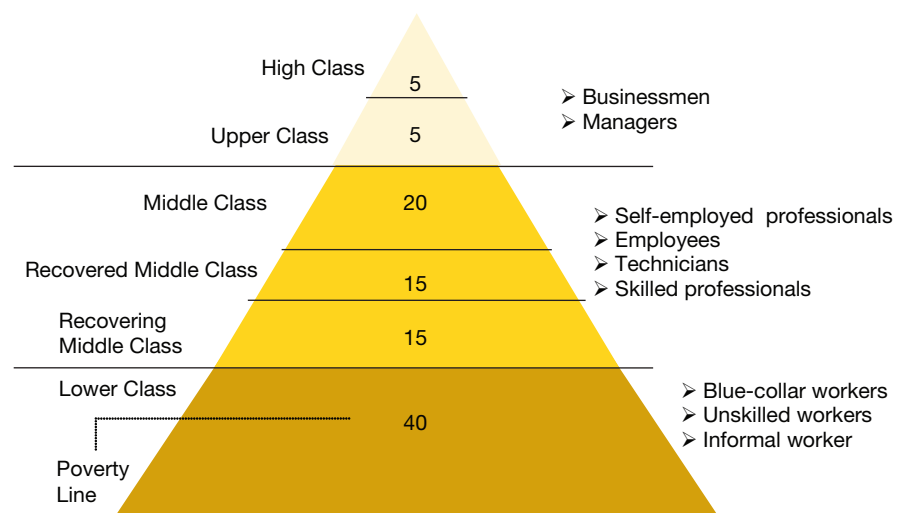
Increasing consumption
of added value products

Increasing consumption of added-value products

2005 saw the return of added value products on the shelves. Products that had become a luxury for consumers after the devaluation recovered a large part of the lost ground and in some cases tripled sales. This category of non-basic consumer goods (from water to frozen foods and deodorants) ended 2005 with an 11% growth. Within this category, the greatest growth was for products such as isotonic beverages, premium beers and health-related food (i.e. yogurts)¹⁴. Premium brands have also followed a strong recovery from 2005 on.

Positive changes in
social pyramid

2006 Social Pyramid



Source: CCR Argentina

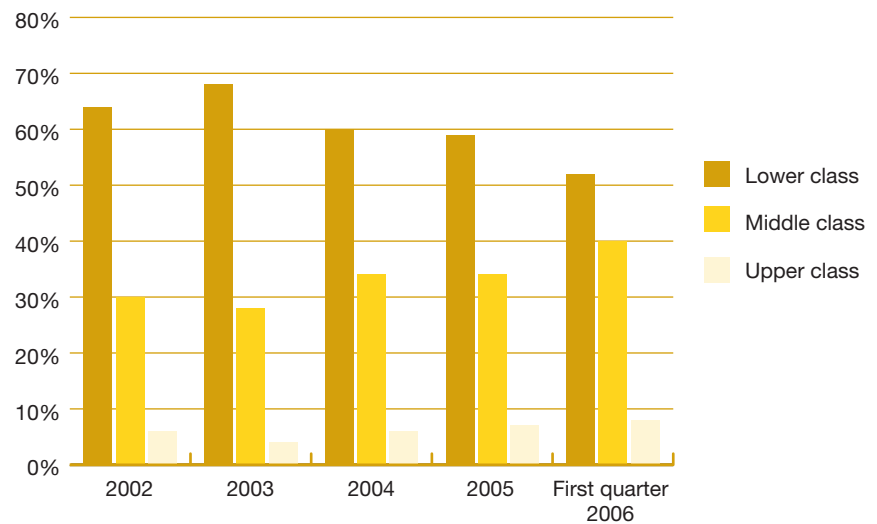
¹³ Source: AC Nielsen, 2005

¹⁴ Source: CCR, 2005



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Average expenditure by social segment



Source: AC Nielsen

Credit-fuelled middle class consumption

The salaries of skilled professionals, technicians and self-employed professionals recovered purchasing power by the end of 2005 and in the first half of 2006. Thus the middle class returned to spend on luxury or non-essential products, thus recovering part of the consumption habits they had had before the crisis of 2001¹⁵.

Wage increases recorded during last years are leading the middle class to expand (from 34% in 2005 to 40% in 2006) and spend more on leisure activities such as dining-out and entertainment, purchase of clothes, paying off debts and loans and purchasing high-tech equipment¹⁶.

Of the money left over after covering basic expenses, 54% of the people spend it on outings & entertainment, 42% on clothing, 36% to cover credit card expenses and repay loans, 35% on home improvements and 35% in savings¹⁷.



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The majority of the middle class is indebted and these debt commitments represent approximately 30% of their salaries. By and large, purchases are made through some form of financing, such as credit card and/or non-interest bearing instalments. Without credit financing, the purchasing power of the middle class would drop by approximately 30%. Two-thirds of the financed purchases are directed to food and essential expenses while the remainder is applied to higher value goods (home appliances, furniture, electronics, etc) or personal loans¹⁸.

*Emerging consumption pattern
for working women*

A recent study shows that 46% of Argentine women work outside the home and this proportion declines as one moves down the social pyramid. These working women spend an average of 7% more than those women who are exclusively homemakers and shop 7% less frequently. Most of women who dedicate a major portion of their time to work are aged between 25 and 49, and like to decorate, be active, keep informed and consume cosmetics, jewellery, books, furniture, home appliances, music and clothes. In this connection, the study highlights that women who keep in good shape assign 12.4% of their basic household budget to buy beauty products, where the preferred items are cold creams¹⁹.

Consumer expenditure

	2003	2004	2005
Consumer expenditure: Total (USD m)	81,802	96,189	112,448
Consumer expenditure (% change pa)	29.7	17.4	16.9

Source: EIU, July 2006

*Lifestyles/
Shopping habits
Continuing preference for
small-scale groceries*

At the end of 2000, sales at supermarket and hypermarket stores represented a bigger chunk of total consumer sales compared to sales at small family-owned groceries. This was facilitated by the opening of new outlets and the transformation of small family-owned groceries into small self-service outlets. This trend, however, reverted in recent years as the drop of population income modified consumer habits. Demand not only shrank but the public could no longer cover its needs with purchases every two weeks or every month as it used to do at larger outlets²⁰.

¹⁸ Source: Oscar Liberman – Fundación Mercado, 2006

¹⁹ Latin Panel Argentina

²⁰ Key Market Argentina Report



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After the 2001 crisis, consumers shifted to shopping at small family-owned groceries and self-services, favouring their proximity and a false perception that they offered lower prices. This trend was strengthened by the fact that these outlets had developed an ever-larger assortment of products. Consumers also became more rational, avoiding purchasing on impulse or for stocking reasons²¹.

All social classes buy at small-owned groceries and self-services. However, this channel is most used by lower-income consumers (blue collar, unskilled and informal workers), representing approximately 84% of their purchases²². Currently, approximately 50% of the middle class has taken to shopping in hypermarkets and supermarkets again (leaving self-services and small family-owned groceries), accompanied by an increase in the consumption of durable goods and thanks to credit based financing. This recovery of customers is accompanied by greater aggressiveness in the commercial policies undertaken by the large retail chains²³.

The following chart shows the drivers that consumers identified as key when deciding where to buy. Closeness and quality resulted as key drivers for the majority of consumers:

Format	1st place	2nd place
Green grocery	Closeness 59%	Quality 49%
Butcheries	Quality 80%	Closeness 50%
Small family-owned self-services	Closeness 69%	Low price 37%
Grocery	Closeness 89%	Quality 16%
Hypermarket	Discount 37%	Closeness 31%
Supermarket	Closeness 63%	Discount 35%

Source: AC Nielsen – Greater Buenos Aires home survey

21,22 Key Market Argentina Report

23 Source: CCR, 2006



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Brand/Price sensitivity *Price-conscious consumers*

Following the 2001/2002 crisis and despite the strong recovery of premium brands during recent times, average Argentine consumers continue to be very influenced by price. Among consumers with highest purchasing power, 50% believe that small-owned groceries and self-services and supermarkets have similar prices, and 19% believe that the prices in small-owned groceries and self-services are cheaper than in the chains. In the lower-income social levels, 33% believe that the supermarkets are cheaper than small-owned groceries and self-services, and 38% estimate that the prices are the same at both. This means that 71% of consumers do not perceive price differences in favour of the small-owned groceries and self-services. However, they do continue to stay away from the supermarkets²⁴.

If prices at the cheaper supermarket chains are compared with small family-owned groceries and self-services, economies of over 15% can be made by shopping in the supermarket chains²⁵.

The rate of inflation and its impact on consumers is one of the issues that the government is taking action about. For example, coordination between the government and supermarket chains has helped generate an offer of basic product baskets at reduced and controlled prices, to assist in making cheaper purchases²⁶.

Cash transactions represent 50% of retail sales

Over the past two years, some banks and large retailers have joined hands to launch promotions for the sale of products with discounts using credit cards in retail stores, generating prices even lower than cash payments. This has helped to attract clients, increase the use of banking services and ensure customer loyalty.

Nevertheless, cash sales represent approximately 50% of total large retailers' sales in the City of Buenos Aires and metropolitan area and 60% of total large retailers' sales in the rest of the country.

Furthermore, in order to use banking services to reduce the level of the underground economy in Argentina (many small family-owned groceries sell only in cash, which hinders the determination of the corresponding taxes), the Tax Authorities have resolved to reimburse customers a percentage of VAT on each purchase made with a debit (5%) or credit (3%) card.

24 Key Market Argentina Report

25,26 Source: AC Nielsen, 2006



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MAJOR CONSUMER GOODS PLAYERS

An expanding consumer goods sector

RETAIL AND CONSUMER SECTOR PERFORMANCE

The strength of internal demand, combined with foreign purchase commitments, is generating a singular scenario for the expansion of Argentina's manufacturing industry segment²⁷.

In March 2006 the Industrial Monthly Index (the Spanish acronym is EMI) recorded a 7.2% increase over 2005 (non-seasonal value). This indicator shows the optimism of companies concerning the development of local and international demand²⁸.

Major consumer goods companies

Ranking	Company name	2005 Gross Sales (ARS m)	2004 Gross Sales (ARS m)	2004-2005 (%)	Category
1	Arcor	3,900	2,790	39.8	Food
2	Massalin Particulares (Altria)	3,207	2,350	36.5	Tobacco
3	Quilmes ¹ Industrial	2,860	2,280	25.4	Beverages
4	Molinos Río de la Plata	2,767	2,949	-6.2	Food
5	Sistema Coca Cola (Bottlers)	2,100	1,900	10.5	Beverages
6	Unilever de Argentina	2,010	1,384	45.2	Cleaning, cosmetics & food
7	Mastellone Hermanos (La Serenisima)	1,599	1,385	15.5	Milk and dairy products
8	Nobleza-Piccardo (BAT)	1,470	1,289	14.0	Tobacco
9	SanCor	1,452	1,204	20.6	Milk and dairy products
10	Danone	1,447	1,650	-12.3	Food & beverages

Source: MERCADO – June 2006

¹ Inbev announced acquisition of majority shareholding of Quilmes



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Food

Ranking	Company name	2005 Gross Sales (ARS m)	2004 Gross Sales (ARS m)	2004-2005 (%)
1	Arcor	3,900	2,790	39.8
2	Molinos Río de la Plata	2,767	2,949	-6.2
3	Danone	1,447	1,650	-12.3
4	Nestlé Argentina	1,082	950	13.9
5	Ledesma (sugar and byproducts) ⁽¹⁾	851	783	8.7

Source: MERCADO – June 2006
(¹) including sales of paper division

Strong competition within the ice-cream segment and ice-cream related products is an emerging trend. It is estimated that sales revenues of ice-cream will amount to ARS600 million during 2006 and an annual growth of 20% is expected. Arcor will invest USD170 million in plants, machinery and purchases in 2006 and 2007 to expand the ice-cream business in Latin America. Nestlé is developing its own chain of home-made style ice-cream shops, investing ARS14 million to strengthen its sales force. Quilmes and Freddo (a local ice-cream premium brand retailer) closed a deal to launch an ice-cream with a beer flavour. Freddo will invest ARS6 million in the expansion of its network of stores in Argentina and abroad, especially Mexico and Colombia²⁹.

Beverages

Ranking	Company name	2005 Gross Sales (ARS m)	2004 Gross Sales (ARS m)	2004-2005 (%)
1	Quilmes Industrial	2,860	2,280	25.4
2	Sistema Coca-Cola	2,100	1,900	10.5
3	Peñaflor	392	333	17.7
4	Agua Danone ¹	345	305	13.1
5	Pernod Ricard Argentina	320	82	290.2

Source: MERCADO – June 2006
¹ Belonging to the Danone Group.



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The consumption of regular beverages increased 15% in 2005 in comparison to 2003. Among the middle and upper middle classes of Greater Buenos Aires, the consumption of “low calorie” beverages is 67% greater than the consumption of these products in the rest of the country. Conversely, average consumption of regular beverages is 18% lower than in the rest of the country³⁰.

In 2006, Quilmes will invest USD20 million in Godoy Cruz (Mendoza) in a Pepsi bottling plant. The company will also disburse USD15 million to double the manufacture of malt at Tres Arroyos (Province of Buenos Aires). Nestlé will spend USD10 million in 2006 to enter the market of flavoured waters with a new plant in Moreno (Province of Buenos Aires)³¹.

Electronics

Ranking	Company Name	2005 Gross Sales (ARS m)	2004 Gross Sales (ARS m)	2004-2005 (%)
1	BGH	1,155	537	115.1
2	New San (Sanyo)	438	113	287.6
3	Whirlpool	257	175	46.8
4	Radio Victoria Fueguina	243	200	21.5
5	Frimetal	160	95	68.4

Source: MERCADO – June 2006

In April 2006, BGH announced the launch of BGH Feelnology, a new brand of electronic products, including plasma and LCD televisions, Home Theaters and DVD players. In addition, during 2006, it has invested in new production lines at its Tierra del Fuego plant.

NewSan S.A. currently hold the licenses for Sanyo, Aiwa, Sansui and other national own-brands. It operates two plants in Tierra del Fuego³².

³⁰ Source: Gustavo Quiroga Investigations, 2006

³¹ Source: Consejo Técnico de Inversiones S.A. Tendencias Report, December 2005

³² Company data (webpage)



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Cleaning and Cosmetics

Ranking	Company name	2005 Gross Sales (ARS m)	2004 Gross Sales (ARS m)	2004-2005 (%)
1	Unilever de Argentina ¹	2,010	1,384	45.23
2	Procter & Gamble ²	1,120	540	107.41
3	Avon	681	585	16.41
4	SC Johnson & Son	410	389	5.40
5	Kimberly Clark Argentina	390	385	1.30

Source: MERCADO – June 2006

¹ Including sales of the foods division, representing approximately 30%.

² 2005 sales include Gillette.

Unilever has been the leading company for cleaning products for 30 years. In 2006 Unilever moved its regional Center for Innovation of the Sedal brand to Argentina. This centre is responsible for developing new products and for the communications strategy for the region. Unilever operates five plants in different provinces and two distribution centres³³.

Procter & Gamble (P&G) owns a plant at Pilar, Buenos Aires and another at Villa Mercedes, San Luis. P&G is currently assessing the possibility of manufacturing Ariel cleaning products in Argentina instead of the current procedure of importing them from Brazil.

Dairy products

Ranking	Company name	2005 Gross Sales (ARS m)	2004 Gross Sales (ARS m)	2004-2005 (%)
1	Mastellone hermanos (La Serenisima)	1,599	1,385	15.45
2	SanCor	1,452	1,204	20.60
3	Suces. de Alfredo Williner (Ilolay)	400	360	11.11
4	Molfino Hermanos	352	310	13.55
5	Milkaut	291	221	31.67

Source: MERCADO – June 2006



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Domestic demand of dairy products increased 11% in 2005 in comparison with 2002, while exports amounted to USD600 million, nearly doubling the figures of 2002³⁴. In Argentina, the yoghurt category is a very important segment in the dairy products sector, as compared to other countries. The “healthy” yoghurt market grew 140% in 2005, in comparison with 11% for basic yoghurts³⁵. During 2006, Sancor will invest USD15 million in the reconditioning of plants and production of yoghurts³⁶.

MAJOR RETAIL PLAYERS

A strong retail segment

Ranking	Company name	2005 Gross Sales (ARS m)	2004 Gross Sales (ARS m)	2004-2005 (%)	Category
1	Cencosud ¹	5,345	3,902	36.98	Hypermarket Supermarket
2	Carrefour	4,471	4,300	3.98	Hypermarket Supermarket Discount
3	Coto	2,531	2,224	13.80	Supermarket
4	Imp. y Exp.de la Patagonia (“La Anónima”)	1,306	1,032	26.55	Supermarket
5	Wal-Mart	1,022	806	26.80	Hypermarket
6	Frávega	924	615	50.24	Home equipment
7	Garbarino	902	615	46.67	Home equipment
8	Maycar	755	332	127.41	Wholesaler
9	Casino (Libertad)	750	748	0.27	Hypermarket Discount
10	Makro	747	774	-3.49	Wholesaler

Source: MERCADO – June 2006

¹ Including sales of commercial centres and shopping malls.

^{34,36} Source: Consejo Técnico de Inversiones S.A. Tendencias Report, December 2005

³⁵ Source: CCR, 2006



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After the acquisition of Disco, Vea and Plaza Vea, Cencosud Group (a Chilean corporation that owns Jumbo supermarket chain, Easy DIY and Unicenter) became the leader of the retail sector, which had historically been led by the French group, Carrefour, made up by Carrefour, Supermercados Norte and Día %.

Cencosud now operates 17 shopping malls and is planning to open a new shopping mall in Mar del Plata and to invest ARS150 million during 2006. Second shopping mall operator is Alto Palermo, which runs 9 centres, mainly in Buenos Aires. Disco is the leader in innovative IT solutions due to an investment plan sustained along several years³⁷.

Carrefour plans to invest approximately 250 million pesos up to 2007 to open six new hypermarkets in the country and remodel the current 28 outlets³⁸.

Coto is the largest local player and has stores in the City of Buenos Aires and Greater Buenos Aires.

La Anónima is leader in Patagonia, both in the number of stores as in its sales level. La Anónima is currently expanding to other regions of the country; for example, it has purchased Supermercados Quijote in 2004, a local chain located in the Province of Santa Fé³⁹.

During 2006, Wal-Mart has already opened three new stores and it expects to open three more during this year.

Out of a total consumer goods market valued at ARS37 billion in 2005, over 60% corresponds to goods distributed through wholesalers to various formats, such as self-service, convenience store groceries, kiosks, drugstores and toiletry stores and shops selling cleaning products. The larger retail supermarkets and hypermarkets and hard discount stores represent 39.8% of the market. The share of the wholesalers and their customers grows out of Buenos Aires City where the sales between wholesalers and supermarkets are shared equally, while the incidence of wholesalers in the Greater Buenos Aires area amounts to 74%⁴⁰.

Retail sales
*Recovering retail sales and
modern retail formats*

37,38,39 Key Market Argentina Report

40 Source: CCR, 2006



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Retail sales

	2003	2004	2005
Retail sales (USD m)	35,218	41,563	48,328
Retail sales growth (% p.a. in ARS)	4.5	13.9	5.3
Retail sales: food (USD m)	16,506	19,203	N/A
Retail sales: non-food (USD m)	18,712	22,360	N/A

Source: EIU, July 2006

The supermarket/hypermarket segment represents approximately 10% of the Argentine GDP. This segment grew steadily until 1998, but thereafter growth was volatile until 2001. The trend has been reversed since 2002; however, a large part of the recovery recorded during 2003 and 2004 is due to the increase in prices that occurred after the devaluation⁴¹.

Only 15 companies of the segment are important, of which 3 operate hard discounts and the rest are directed to the formats of supermarkets, self-services and hypermarkets⁴².

Although the number of products on sale basically depends on the selling space available and the product policy adopted by each company; the recession, the search for lower costs and the devaluation has obliged companies to optimise the number of products sold⁴³.

Breakdown by number of stores for main players

Number of stores	Hypermarkets	Supermarkets	Hard discount stores
2005	91	731	491

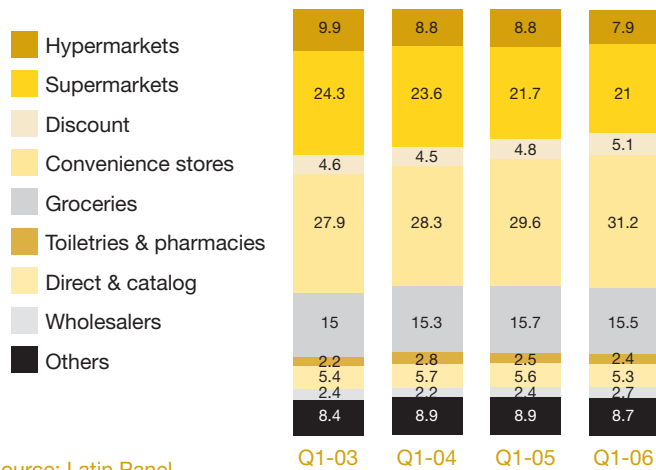
Source: Company data

In 2004, there were around 106,000 retail sales outlets for food items, a large number of which also sold other products for family consumption, basically cleaning products and toiletry. Out of that total, 14,000 shops, belonging to 9,000 companies, use the self-service format⁴⁴.



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Market share by retail format

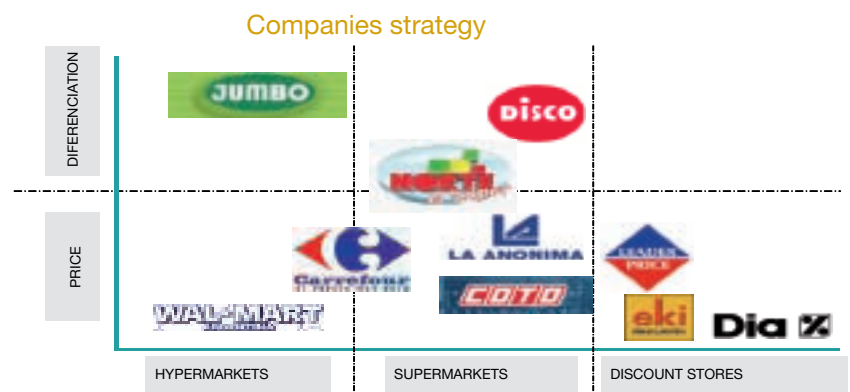


At the end of the 90s, the supermarket and hypermarket channel represented approximately 50% of the market, a similar level to that registered in developed countries. Currently, and due to local crisis this share represent only 40%.

Gaining a competitive advantage for supermarkets and hypermarkets⁴⁵

The strategies of the various supermarkets and hypermarkets to gain a competitive advantage vary from lower price to differentiation through quality and service.

The following picture shows the different competitive strategies of main supermarket and hypermarket chains:



Source: Key Market Argentina



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Carrefour holds specific events to show that it is the cheaper option; for example: “Week of cleaning goods”, where prices in that category are between 15-20% cheaper than competitors’. Both Carrefour and Norte have reinforced marketing and sales of their own brands in order to obtain higher profit margins. Similarly, Wal-Mart has launched a range of programs to reinforce its lower price strategy. It offers price reductions over an extended time; sale of items with a gift product or additional quantity over a limited time and reimbursement of twice the value of the product if the customer is not satisfied with it.

Disco’s competitive advantage, on the other hand, is gained through customer recognition, due to the high quality of its products and the wide range of exclusive services it renders. One of the main characteristics of its strategy is the segmentation of its stores into two formats: “Service Oriented” and “Price Oriented”, offering various services to the customer in accordance with local, regional and environmental influences. “Service Oriented” stores made up by the Disco brand are aimed at customers willing to pay a special price in exchange for higher quality and a wider variety of products and service. “Price Oriented” stores are made up by the Super Vea, Plaza Vea and Minisol brands.

Jumbo supermarkets have the highest penetration in the upper class population and the greatest customer loyalty. Focused on client service, Jumbo is currently the leader in the quality segment. Jumbo has launched a customer loyalty initiative through the “Tarjeta Jumbo Más” purchasing card that accumulates points that can be redeemed for products.

Food retail channels

Hypermarkets

*A small segment dominated
by foreign players*

Group name	Store brand	Number of stores (2005)
Carrefour	Carrefour / Norte	28
Cencosud	Jumbo / Disco / Vea / Plaza Vea	24
Casino ¹	Libertad	13
Wal-Mart	Wal-Mart	12
Coto	Coto	11
Supermercados Toledo	Toledo	2
Cooperativa Obrera	Cooperativa Obrera	1
TOTAL		91

Source: company data

¹ It also has 20 minimarkets.



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Supermarkets
Also led by foreign player

Group name	Store Brand	Number of stores (2005)
Cencosud	Disco Vea & Plaza VEA	294
Carrefour	Norte	114
Coto ¹	Coto	78
Imp. Y Exp.de la Patagonia ²	La Anonima /Quijote	95
Millan	Atomo Supermercados	66
Cooperativa Obrera	Cooperativa Obrera	54
Supermercados Toledo	Toledo	30
TOTAL		731

Source: Company data

¹ It also has 20 minimarkets

² It also has 11 minimarkets

Discount stores
A segment showing
promising growth

Group name	Store Brand	Number of stores (2005)	2005 Gross Sales (ARS m)
Carrefour	Supermercado Dia%	319	600
Eki	Eki Descuento	144	179
Casino	Leader Price	25	N/A
Supermercado Toledo	Ahorro Fácil	3	N/A
TOTAL		491	

Source: Company data and MERCADO – June 2006

This retail segment grew dramatically from 1998 to 2003 in terms of stores and sales. Since 2003, growth rates have stabilised in accordance with other segments.

Eki Descuento began operations in 1996 with two stores and from then on has had a sustained growth until 2001. In the past two years, 15 new stores were opened⁴⁶.



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Group name	Store brands	Number of stores (2005)	2005 Gross Sales (ARS m)
Maycar	Vital	14	755
Supermercado Mayorista Makro	Makro	15	747
Maxiconsumo	Maxiconsumo	25	611
Diarco	Diarco	19	630

Source: Company data and MERCADO – June 2006

Vital has more than 80 years of wholesale business experience. Vital has a fast access telemarketing system that allows customers to make long distance purchases with delivery to the interior of Argentina, with the incentive of promotions, discounts and credit card payments⁴⁷.

Makro Argentina sells a large volume of food and non-food products but only to registered customers and is not open to the general public⁴⁸.

Maxiconsumo has the greatest number of stores in Argentina. It has its own brands and labels like: Marolio and Freshy (food and beverage products); Esencial and El Buda (cleaning and home care), and Patricia Allen and Just Baby (perfume and hygiene)⁴⁹.

Non-food retail channels

Home equipment

A strong emerging trend

Company name (Store brands)	Number of stores (2005)	2005 Gross Sales (ARS m)
Frávega	69	924
Garbarino	49	902
Ventura	N/A	141
Saturno Hogar	14	165
Electrónica Megatone (Red Megatone)	181	96
Marquez Group	151	N/A

Source: Company data and MERCADO – June 2006



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DIY Growing popularity

Fravega's strategy is to be the leader in all the product segments favoured by customers. As hi-tech products are fashionable at the moment, Fravega is responding with the development of Frávega Tec and Big Frávega. The former is an area of 200 square meters selling state-of-the-art sophisticated technology and the latter is a gigantic space with a wide variety of products. Fravega plays on consumer pleasure and service and its strategy is client focused, giving financing solutions as well as special advice to consumers.

Group name (Store brands)	Number of stores (2005)	2005 Gross Sales (ARS m)
Easy (Cencosud Group)	27	326
Blaisten	9	126
Barugel Azulay	7	69

Source: Company data and MERCADO – June 2006

Easy provides all necessary home furnishings and products in a self-service format under one roof, thus allowing the customer to save time. In addition, it offers expert advice on products and their use at the customer's request, rental of equipment, free wood cutting, carpet cuts, colour centre for preparing the paint and instruction courses⁵⁰.

Blaisten is currently the leading brand in the sale of ceramics, bath and cooking appliances. Since the sixties, Blaisten has grown and opened several stores in different parts of the City of Buenos Aires and Buenos Aires Province⁵¹.

Barugel Azulay is dedicated to home equipment and construction, selling appliances, equipment, products and services. It was recently acquired by the Saint Gobain Group⁵².



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Pharmacies *An expanding segment*

FarmaCity, leads the pharmacies market. It began activities in 1997 and offers pharmaceutical products, medical specialties, chemical products, cosmetics, toiletry and other consumer goods. Seeking to position itself in consumers' minds, Farmacity always looks for the best sites to locate its stores, with a format similar to the top pharmaceutical retailers of USA and EU. The company's future expansion plans include opening more stores, become the top of mind brand name for customers and the leader in the pharmaceutical market⁵³.

E-commerce *A nascent retail channel*

The e-commerce business is currently starting to develop in Argentina. In recent years, only a few retailers have adopted online sales (e.g. Disco and Rosental e hijos) while other hypermarkets sell by phone. The only pure online retailer is LeShop.com.ar, with a low level of activity.

The main home equipment companies sell on the internet; for example, Garbarino, Dromo and Frávega. Department store chain Falabella offers sales over the internet with special offers and discounts.



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RETAIL AND CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

CHALLENGES

Focus on value
creating activities in an
environment of strong
price competition and
discounts

After the 2001 crisis, the hypermarket and supermarket channel lost market share as compared to other retail channels. Although a slow recovery can be seen today, current market share has not yet returned to the 1995 to 1999 levels.

There is strong competition among the large chains to benefit from the recovery and gain additional share. Players in the market tend to select strategies which favour lower prices and temporary promotional discounts on specific products as a means of competition.

This system of strong discounts, which was implemented by low prices chains as a way of differentiating from other chains, is now being used as a common and recurring strategy by most chains. The customer perceives these benefits as “commodities” since they are not sufficient to differentiate one chain from the rest. This “discount war” now appears to constitute a downward spiral for the industry, generating a continued erosion of company profitability.

To break this trend, the large chains are faced by a new challenge: to achieve a renewed “value-based” differentiation that will allow them to gain market share without affecting profit margins. In other words, chains should seek to achieve greater differentiation through quality and service following global and regional trends.

Another challenge is to achieve added-value and attract attention from the upper and middle class segments, which demand more innovative services such as telemarketing or online sales, differentiation in variety and quality of products, specialised counselling, more attractive fidelity programmes, etc.

On the other hand, given that channels other than modern retail represent a significant portion of their sales, consumer goods companies have also developed a relationship with those players, where suppliers feel stronger to negotiate sales conditions.

Gaining efficiency in the
supply chain by applying
new technologies and
processes

When the goal is to improve profit margins, the logistics chain plays an essential role in the interest of greater efficiency and greater sales volume. Practices such as planning and collaborative supply between the retail companies and their suppliers help to locate areas of opportunities for improved efficiency. Some of the practices that companies are currently evaluating are:



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- Vendor Management Inventory (VMI): This consists in a mechanism where the supplier is in charge of planning and generating purchase orders through information on sales and stocks provided by the retailer. To ensure the sale of products on the basis of expected demand and stocks and to reduce errors at the point of order is work that passes from the hands of the retailer to those of the supplier, who in this way establishes a comfortable win-win situation, which also favours its customer, the retailer.
- Radio Frequency Identification (RFID): RFID technology is aimed at locating the products throughout the logistics chain; it will replace the bar codes and make a difference by automating processes and integrating companies. By providing more and better information on stocks, RFID makes it possible to know the characteristics of the product, where it is and its status at all times. At this stage, analysis of RFID's future implementation is focused on movements among warehouses, without installing it on stores selling space.

Retail companies and their suppliers must work together and find alternatives to cut costs throughout the logistics chain and ensure the timely availability of the merchandise at the point of sale. Collaborative work practices are beginning to be implemented very gradually in Argentina, but no doubt there is still a long way to go.

Achieve sustainable profitability in a price agreement scenario

Rising inflation is identified as one of the main threats to the current health of the Argentine economy. In order to fight inflation, current government strategy focuses on price agreements.

While the government has attempted to extend these agreements across the board, it has focused its efforts on sectors such as food, gas, and other household goods, which impact the Consumer Price Index (CPI) directly. These sectors also directly affect the lowest socio-economic strata, which constitute the Argentine President's political base. While the retail sector as a whole is vulnerable to such pressure, sectors whose products affect the CPI can expect to be singled out for particular attention.

Throughout the first quarter of 2006, both the President and Finance Minister took part in negotiating and signing price agreements. Since price agreements have focused on products that affect the CPI, sometimes companies have



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been able to offset price restrictions with increases on other goods but the price-controlled goods list is increasing month after month. Robust economic growth over the past three years with little prospect of a slowdown in the near future, as well as vigorous growth of consumption, have allowed companies to weather these pressures.

This price agreement scheme, operating in an industry environment of payroll increases, has obliged retailers to concentrate efforts on improving the marketing mix and operating effectiveness, reducing costs and developing new business alternatives in order to achieve sustainable profits and interesting ratios on a mid-term basis.

OPPORTUNITIES

Favourable environment resulting from the growth of GDP and the recovery of internal consumption

At the beginning of the century, Argentina recorded the most severe crisis of its modern history, in economic and social terms, but as from the second quarter of 2002 the economy stopped dropping and began a process of strong and constant recovery, accumulating approximately 30% in growth. Thus, together with China, Argentina heads the list of countries in which the variation in GDP has been greatest in the 2003 to 2005 period. At regional level, since 2003 Argentina has been the Latin American and Caribbean economy that has recorded the highest rates of GDP growth.

The recovery of salaries and employment has had a favourable impact on home consumption which, since the beginning of the recovery in 2003, shows an upward trend reaching, in mid-growth, values prior to the crisis.

Thanks to the recovery of the purchasing power, the supplementary categories of packaged food and non-food segments (those with greater added value, such as foodstuff, toiletry and cosmetics for example), reflect an upward trend in consumption in comparison with the basic categories (price intensive) since 2003.

The grocery market also shows a readjustment of market share of the traditional top brands displacing the second-line brands that appeared during the crisis.

The Argentine economic recovery is creating business opportunities for new investments, in manufacturing and in services, as well as those necessary to take over markets and establish brands. It must be remembered, however, that after the crisis, the profile of the Argentine consumer underwent a profound change; consumers have become highly demanding, requiring quality, valuing brands on the basis of their yield and appeal, since price is no longer a valid indicator in itself. Brand loyalty can no longer be taken for granted.



Argentina

Internationally
competitive production
and labour costs

Modern industrialisation
associated to the growth
of the primary industry

Argentina is one of the most competitive economies on the international market. Recent developments in the Argentine economy have involved a change in relative prices, with a rate of exchange more devalued in real terms and a far lower cost in terms of capital yield, generating a production breakdown different to the one prevailing several years ago and at present it is the tradable sectors that have gained greater space in the breakdown of GDP.

The cost of office/plant purchase or rental, as well as salaries and utilities are at very competitive levels in comparison with other countries in the region and the rest of the world. In the manufacturing sector, for example, the labour cost per product unit is at its lowest since 1990, which is due to the real decrease in labour cost and a greater increase in productivity.

Argentina also has a set of systems destined to encourage investments, with incentives of a sectorial nature, promotion of exports, investment activities and regional advantages.

In the primary sector, Argentina is the sixth world exporter of foodstuff and a leading player in the world agriculture and live-stock market, in a varied range of products.

Within this stage of growth in the economic cycle, there has also been a recovery in industries related to the primary activity. For instance, Argentina is the first producer and exporter of sunflower oil, third worldwide producer and exporter of soybean oil, sixth world producer of wine, second world exporter of peanut oil, second most important seller of concentrated apple juice.

Argentina has a modern and diversified industrial structure, being noted for its high level of labour productivity, emphasis on export and presence of trans-national firms. This is evident in the growth of exports by over 200% from 1993 to 2005.

Investment by foreign companies in Argentina since the crisis is in full recovery, increasing its share in tradable sectors of the economy. In the manufacturing industry, the foodstuffs industry was favoured by the recovery of the internal market, the access to new export destinations and the high rate of profitability, which encourage continued growth in foreign investment.

In this context, and considering the competitive cost advantages mentioned in previous paragraphs, an increase of exports of value-added products derived from current agribusiness activities is likely to happen and appears as an attractive business alternative.



Argentina

EMERGING TRENDS

Consumer preferences regarding retail channels

Since the crisis, changes have occurred in consumption habits, mainly in the rationale and regularity of the purchases. There has been a growing trend in the share of the self-services and small supermarkets as well as that of hard discount stores.

Hard discount stores, despite their low share at the moment, are expected to grow. Some players have already incorporated discount stores in their portfolio and will probably incorporate more in coming years. This is mainly due to the fact that they want to attract the customer who is currently purchasing in the self-service and supermarket channel, which having a system of high volume/turnover and little variety, represents a good opportunity for price negotiation with suppliers, also making the logistics scheme more efficient.

The traditional wholesale channel has also grown very quickly during the last 3 years, but is threatened by the greater logistic efficiency that could take the products directly to the retailer, overtaking its role in the supply chain. Some supermarket chains (e.g. Coto and Carrefour) have already incorporated a wholesale sector among their formats, which could also threaten wholesalers traditional “business-to-business” channel positioning.

Implementation of loyalty practices

Customer loyalty practices are increasingly being applied in Argentina. An example is the programme of customer benefits granted on the basis of points accumulation based on consumption.

Launching or repositioning of own credit cards systems originally arose from the lack or high cost of obtaining credit, and as a way of differentiation by granting flexibility in the payments. Today, it is emerging as a tool for creating loyalty as well as for credit purposes. Through the credit and loyalty cards, high value data on the customers is obtained, which could be processed and analysed to increase sales.

Retail players' concentration

Efforts of the large chains are currently directed at capturing a greater market share through economic concentration. This concentration, in which brands prevail to diversify risks, is encouraged by facts such as the stability of the rate of exchange and the socio-economic context, and is reflected in purchases of large chains and opening of discount stores. The purchase of Supermercados Norte/Tía by Carrefour, the purchase of Home Depot and Disco by the Chilean group Cencosud, the acquisition of local small players by La Anónima, Wal-Mart's interest in the purchase of local mid-size players and the current expansion of Carrefour, Casino, Coto and Jumbo in various regions and formats are several examples.



Argentina

Expansion rates in relation to non-food retailers are also expected to be higher than in the past. Nearly all shopping centre operators have announced significant growth plans for the near future.

In terms of CPG companies, concentration of players has also been confirmed as a trend during last couple of years; M&A activities mainly involved both multinational and local big players acquiring large or mid-size local companies.

Large chains go to the provinces

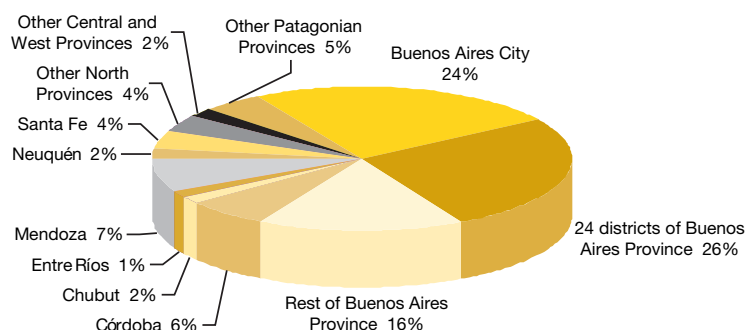
It is expected that in a year and a half, some 30 new commercial centres will open in provincial capitals and cities.

Supermarkets and shopping centres are moving to the interior of the country (i.e. all Argentine locations other than Buenos Aires and Greater Buenos Aires). The recovery of regional economies, added to the lack of growth opportunities in Buenos Aires due to maturity ratios, has caused the largest retail chains to give priority to the rest of provinces in their expansion plans.

The plans include the development of supermarket chains as well as shopping and commercial centres. The South continues to be the most attractive zone given the combination of the greater affluence of international tourism and the impact that the international price of oil has on the economy of the Patagonian provinces. However, there are also openings of shopping centres and supermarkets planned in cities such as Corrientes or San Juan, which are not benefited by any of these factors.

The following pie-chart shows that almost two-thirds of supermarket stores are located in Buenos Aires City and Buenos Aires Province. That is why the other provinces of the country arise as an opportunity for developing new markets.

% of Stores by Province 2005





Argentina

Buenos Aires City and Buenos Aires Province represent 46% of total population and account for 2/3 of supermarkets

Macroeconomic factors are favourable, to which we can add the fact that the real estate price in the interior is still a bit lower than in Buenos Aires. Thus, the interior of the country is a good market in which to invest and the idea is shared by Easy (largest DIY chain), which has just announced an aggressive expansion plan to double its network of stores in the coming four years, focusing on the interior of the country. Easy has confirmed the inauguration of the third store in Córdoba for 2006 and it is expected to open a store in Salta. The owners of Easy, the Cencosud Group, are also promoting a couple of projects of shopping centres in Yerba Buena (Tucumán) and Trelew (Chubut), and before year-end will begin construction to open two supermarkets in General Roca and Puerto Madryn (South locations).

A direct competitor of Easy, the Santa Cruz Province chain Hipertehuelche inaugurated its ninth branch in Caleta Olivia and now projects openings in Río Grande, Ushuaia and Comodoro Rivadavia. Another player that is very active in the interior of Argentina is Wal-Mart. The chain opened a hypermarket in Río Cuarto and has confirmed its arrival in Corrientes, San Juan, San Luis, Tucumán, La Rioja and the opening of a second store in Mendoza, with investments of over USD100 million.

Carrefour Group has recently announced a very aggressive growth plan requiring USD150 million investment from 2006 to 2008, for a project of opening 30 new stores around the country (15 under Carrefour brand and 15 under Norte brand), including provinces such as Entre Ríos, Tucumán, Chubut and Tierra del Fuego. Most of these new stores will have smaller selling space than the stores managed under the Carrefour brand to date, in accordance with requirements from both customers and profitability indicators.

There are other projects that should be mentioned, such as the shopping mall that a Chilean player will develop in Río Grande (Tierra del Fuego), the commercial centre that is being built by the development company Eidico in Ushuaia (with an investment of USD10 million), the mega-shopping mall of G&D in Neuquén (a venture that will cost USD23 million), the Innsbruck strip mall in Cariló, the La Normandina food patio in Mar del Plata, a supermarket of Cooperative Obrera in Villa Regina and a couple of proposals for shopping in Santa Rosa and Bariloche.

The phenomenon of the shopping centres is not exclusive to the large provincial capitals, as it was in the past, but it is slowly arriving to medium-sized cities such as Rafaela (Santa Fe) and Villa Carlos Paz (Córdoba), where there are projects in progress.

Case Study I



Shared Service Centre – optimising functional efficiency

KEY DRIVERS

In a significant trend, CPG companies with subsidiaries in different countries and locations have begun to choose Argentina as the central point in which to install Shared Service Centre with a regional Latin-American or continental coverage. The main drivers are to cut costs and generate scale economies and to focus business units on their core activities.

This case relates the experience of a large world-wide company engaged in the production and sale of non-food mass consumer products. PricewaterhouseCoopers Argentina acted as a significant part of the client implementation team.

Main objectives

Within the framework of a global program to achieve financial functional excellence and in order to implement the idea of “finance as a strategic business partner”, the Company studied the possibility of setting up a financial Shared Service Centre for Latin America in one of the countries of the region.

The purpose was not only to cut costs, but to migrate support activities, perceived as “not generating value” to a specialised team, converting it into a “core business”, and making the regional operating administration of finance more efficient. This would also help to strengthen the internal control environment and compliance with Sarbanes Oxley regulations.

The Shared Service Centre was implemented to provide a range of services including accounting and reporting, treasury, accounts payable, payroll and serving as a contact centre for all Latin American suppliers.

Why Argentina?

One of the essential issues in the definition of the business case was the selection of the location to install the Shared Service Centre. After an exhaustive analysis of possibilities, the city of Buenos Aires, Argentina, was finally chosen due to the following factors:

- The availability of highly university-qualified English-speaking resources
- Quality of life and safety
- Modern communications infrastructure
- Internationally competitive costs

- Reduced time difference with the principal centres of the USA and Western Europe
- Labour laws that establish a flexible legal framework
- Availability of relatively cheap physical infrastructure

The procedure

Once the decision and the location were confirmed, a cross-functional project team was put together, with experienced resources from other regions and a team of outside consultants, made up by PricewaterhouseCoopers personnel.

Work teams were organised, specialising in various processes, with experts in business and in technology and a project office was created to be in charge of permanently monitoring the progress. Two directors, from business and technology areas respectively were appointed as responsible for them.

At first, the main responsibilities of the work teams were: the definition of a strategy for the migration of processes from the various countries involved to the Shared Service Centre, the definition of communications mechanisms with the various stakeholders and company employees (given the critical nature of the transformation process) and definition of detailed work plans for each of the work teams.

Once the guidelines for each of the work teams had been defined and validated, work was focused on the standardisation, improvement and migration of the processes involved as well as the gathering and transfer of knowledge concerning the specifics of the countries affected by the Shared Service Centre.

The service management function was also created, in charge of permanent monitoring and improvement of the centre in terms of efficiency and of arbitrating in the relationship and fulfilment of the levels of services previously agreed with the client business units. This area is also in charge of monitoring the contact centre developed.

The implementation involved the centralisation of the finance back office for fourteen locations, from Mexico to Argentina and was carried out over one year.

Impact

From a general point of view the centre became a “business partner” for the Latin American Finance group, with a single work platform for the region, a strong internal control environment and centralisation of the regular reviews required by Sarbanes Oxley regulations. This simplified the administration of accounts and funds for the group as a whole.

- Impact on internal clients: The centre’s client areas (Finance, Sales and Supply Chain in each of the countries) were able to improve the operation-management ratio, going from a 50:50 ratio to a 20:80 ratio and once relieved of the operative work, were able to engage in the analysis and improvement of their core responsibilities.
- Impact on outside clients and suppliers: Company suppliers began to benefit from the streamlining of the process of accounts payable and from having a single contact point which handles all their consultations and doubts on the life cycle of the relationship (except for the administration of contracts).
- Impact on employees: High yield motivated work teams were created, in the service centre as well as in the business units, as they all had common objectives requiring a strong synergy to achieve them. The cultural diversity contributed to the professional and personal development of the persons involved in the transformation process.

PRICEWATERHOUSECOOPERS ASSISTED IN THIS CASE BY PROVIDING THE FOLLOWING SERVICES:

- Design and preparation of an implementation plan. PricewaterhouseCoopers also assisted in the definition of implementation roles and responsibilities for the different countries and processes.
- Review of the processes in place in various countries and identification of the best practices to design standard processes for all countries.
- Participation in defining a work shadowing plan, designed to transfer knowledge from each of the countries to the Shared Service Centre in the best way.
- Definition of a communication strategy for all the stakeholders and employees as well as the suppliers.
- Development of a recruiting and retaining plan, as well as a service and performance culture plan.
- Development of a global monitoring plan regarding the project, lasting between one and two years, where control activities, follow-up and process tracking were defined and delivery templates, timetables and work monitoring were established to supervise compliance with original plans.
- Design of the service agreements to be signed by the Shared Service Centre and the countries where the functions and roles of each were defined. PricewaterhouseCoopers also assisted in the design of operating manuals.

Case Study II

Leveraging the wine industry in Argentina for export

KEY DRIVERS

Following a flurry of investment in the 1990s, the 2002 devaluation caught the wineries well prepared technologically. Argentine wines had begun to be recognised as coming from a different terroir, with flavours and aromas that distinguish them as unique in the world. The devaluation led to an improvement in the prices at which Argentine quality could be sold abroad. Today, Argentina concentrates 5% of the global production, but only represents 1.5% of international wine sales reflecting a clear opportunity for development.

This case relates to investors from the wine industry of South Africa who arrived in Argentina at the beginning of year 2004 and located in Mendoza, the principal wine producing Province of Argentina, with the intention of taking advantage of the main characteristics of local industry. What steps did they take?

Main objectives

The core business is to buy bulk wine of a certain quality and export either bulk or bottled wine to European markets, mainly to UK. The main aims of this initiative were:

- To leverage the current excess capacity of the local industry
- To work with the highly-qualified human resources counter seasonally
- To leverage the internationally competitive costs

Why Argentina?



Location of main wine producing facilities	
Province	Hectares
Mendoza (1)	70%
San Juan (2)	22%
La Rioja (3)	4%
Rio Negro y Neuquén (4)	2%
Catamarca (5)	1%
Salta (6)	1%
Total has	212.658

Main Grape Types		
Typical Top Wines	Malbec Merlot Cabernet Syrah	Chardonnay Sauvignon Blanc
New Top Wines	Bonarda Tempranillo Pinot Noir	Viognier Chenin Pinot Blanc
Low Price	Cereza Barbera	Pedro Grímenez Moscatel de Alejandria Torrantes

Source: Instituto Nacional de Vitivinicultura

In the 90s, an industry turnaround process started. An important trend of foreign investment destined to the development of land and new technologies gave a great boost to wine production, improving the volume as well as the quality of the product.

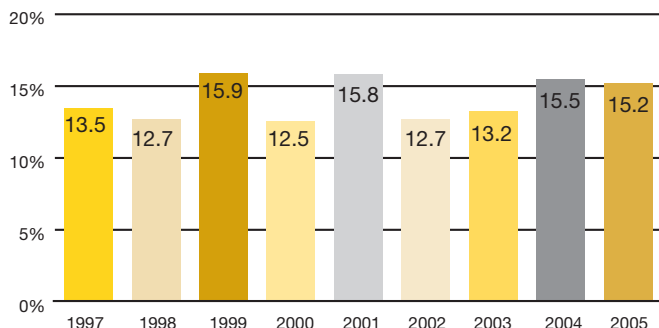
Old ideas were abandoned and the definition that prevailed in international markets was adopted. The cultivation of vines was modified in an attempt to produce greater intensity of flavour and aroma instead of maximising the number of kilos per hectare, implementing stocks with lower yield. Wineries were radically transformed, equalling the most modern in the world. World-famous consultants were engaged to provide the knowledge for developing wine-growing regions.

The wine industry has invested around USD1,500 million in its development over the last 15 years, and it is expected that USD200 million more will be invested until 2010. 67% of the investments correspond to capacity increase and modernisation of existing wineries, 28% to new investors developing new wineries and 5% to mergers and acquisitions. In addition, 7 of 10 investors are focusing on exports while the rest mainly focuses on domestic consumption.

Considerable rates of return can be obtained from any profitability analysis of an investment in the wine producing industry in Argentina due primarily to a lower cost of land versus other suitable wine-growing countries (for example, the cost of a hectare in a top European zone is from USD70,000 to USD1,000,000 while the average per hectare in Argentina is USD30,000).

Due to the economic and political environment of Argentina, labour costs and raw materials have fallen in terms of dollars pushing up the competitiveness of the country. As a consequence of this crisis, the industry has developed important possibilities for the export of wines with a very good quality-price ratio (mainly Malbec grape) and which have been awarded in international markets.

Argentina wine production
Numbers in thousand of hectoliter



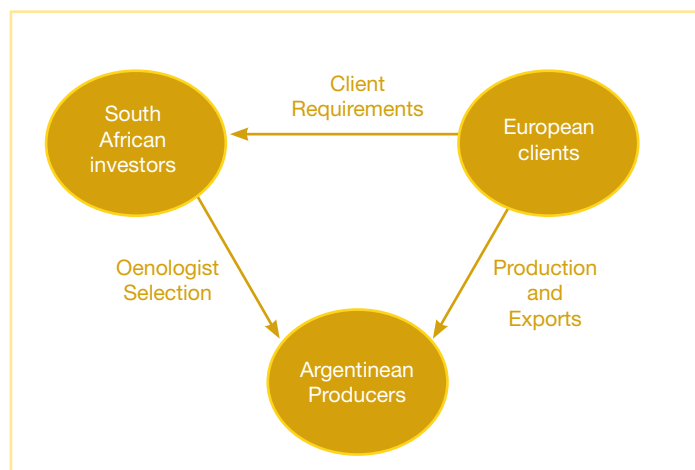
Source: Instituto Nacional de Vitivinicultura

In 2005, wine exports amounted to USD431.9 million, an increase of 33% compared with 2004. A 25% greater volume is expected for 2006 (30% in wines and 10% in grape juice), and again a new invoicing record will be achieved. Exports have been the key factor triggering the sector boom and will lead to a greater growth in the long-term.

The procedure

With the support of an English oenologist, who works counter seasonally and focuses on the quality, taste and type of wine required by international clients, the company buys bulk wine from local producers personally selected by the oenologist. It then outsources the bottling and casing process, keeping the lowest possible investment in fixed assets and ensuring the sale of the whole production, both with own and client labels (white labels for supermarket chains).

Business Model



Key success factors

- Hundred percent client focused: every year the wine bought and produced is in line with client expectations and demands.
- Oenologist with international experience who works counter seasonally and represents a lower cost for the Argentine company.
- High flexibility because of the lack of fixed assets and long-term agreements with producers.
- A very attractive business plan that leverages the competitive advantage of all the players: South African wines currently hold a significant position amidst "New World" wine players, European client demand for new wine experiences and tastes and Argentina's surplus production capacity and lower production costs that make easy to maintain quality without jeopardising profitability.

The outcome

After a year of activity, and supporting the success of Argentine wines in international markets, the company ranked between the five most important wine exporters of Argentina with a profitability of around 17% (higher than the market average).

PRICEWATERHOUSECOOPERS ASSISTED IN THIS CASE BY PROVIDING THE FOLLOWING SERVICES:

Taking advantage of a vast body of experience in the wine industry, PricewaterhouseCoopers assisted the client in customising its foreign business model to the local environment in terms of:

- Legal support in defining the best type of association scheme with local producers.
- Defining the financial structure for the operation and the relationship with banks.
- Advisory services in customs and tax schemes to be implemented. This was an important issue considering that whole production would be sold outside Argentina.
- Human resources recruitment in both administrative and operational areas.



Argentina

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Brazil



Area ('000 sq km)¹: 8,500
(US 9,600 – EU25 3,981 – World 133,700)

Capital²: Brasilia
(Number of inhabitants: 3.6 million)

Population (million): 181.4
(US 296 – EU25 459 – World 6,000)

Median age³: 28 years

Nominal GDP (USD billion): 795.7
(US 12,487 – EU25 13,447 – World 44,183)

Nominal GDP (USD billion at PPP): 1,557.9
(US 12,487 – EU25 12,657 – World 59,763)

GDP per head (USD at PPP): 8,587.8
(US 42,129 – EU25 27,538 – World 9,962)

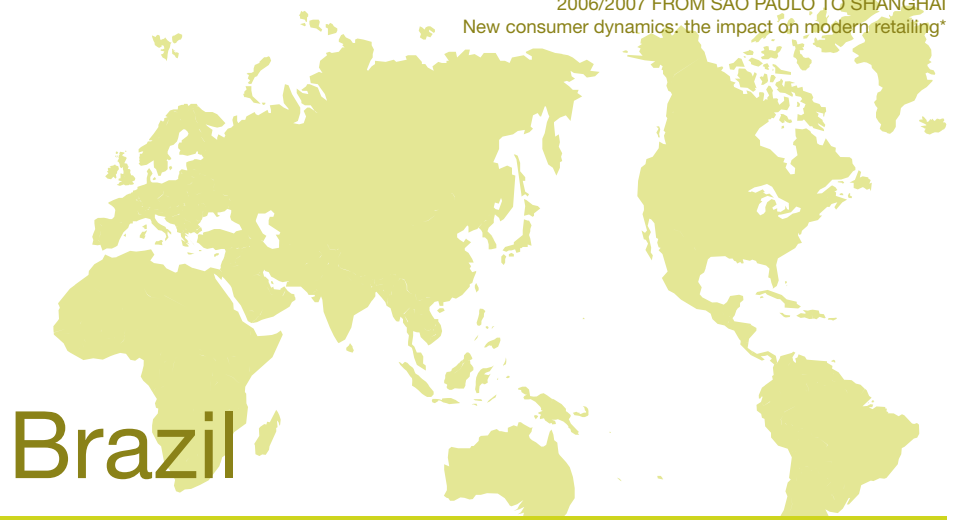
Currency³: Real (BRL)
(USD1 = BRL2.4)

Languages³: Portuguese

Main religions³: Roman Catholic

Government type³: Federal Republic

Sources: () Economic Intelligence Unit 2006 data,
(¹) World Bank 2005, (²) City Population,
(³) CIA Fact book



Brazil

GDP AND CPI

Focus on economic policy priorities

ECONOMIC OVERVIEW

An emerging global player

Brazil is the 5th largest economy in the world with a GDP of 796 billion USD in 2005 and a population of 181 million. This level of GDP was achieved despite significant parts of the population being at very low income levels and thus falling outside the consumer bracket for most of the relevant markets.

Nevertheless, rather than focusing on growth, during the last few years, economic policy priorities have concentrated on adjusting the economy's fundamentals – namely reducing inflation to reasonable levels, adjusting the fiscal and foreign exchange deficits and reducing the country's foreign debt to make it less vulnerable to fluctuations in the world economy. There still is a lot to be done, but in general terms, these main objectives have been achieved.

This however has had a cost. In contrast with the average economic growth rate of vigorous emerging markets, in recent years the Brazilian economy has been characterised by erratic growth levels. This apparent low performance resulted from a rigid monetary policy and high interest rates to reduce inflation, but also severely affected domestic consumer demand and investment.

The appreciation of the Brazilian currency (Real) of around 15% in 2005 was also responsible for the decrease in competitiveness of exports, despite the 22% increase in 2005 and 100% over the last 5 years.

GDP and CPI

	2002	2003	2004	2005
GDP growth (%)	1.9	0.6	4.9	2.3
CPI (%)	8.5	14.7	6.6	6.9

Source: EIU, July 2006

UNEMPLOYMENT

Falling unemployment

Unemployment levels are relatively low in comparison with developed countries. Moreover, due to weak state support towards the unemployed, there is a large informal work market.

Under this scenario, there has been a significant reduction in unemployment, from 12.3% in 2003 to 9.8% in 2005. A rise in formal and qualified employment reflects an upgrade in the quality of the labour force.



Brazil

However, despite government efforts to create new job opportunities, a further dramatic reduction of the current levels can only be expected with annual economic growth rates above 4% and after structural reforms in the labour relations and social security areas.

Unemployment

	2002	2003	2004	2005
Unemployment rate (%)	11.7	12.3	11.5	9.8

Source: EIU, July 2006

ECONOMIC FORECAST

Reaching higher economic growth rates

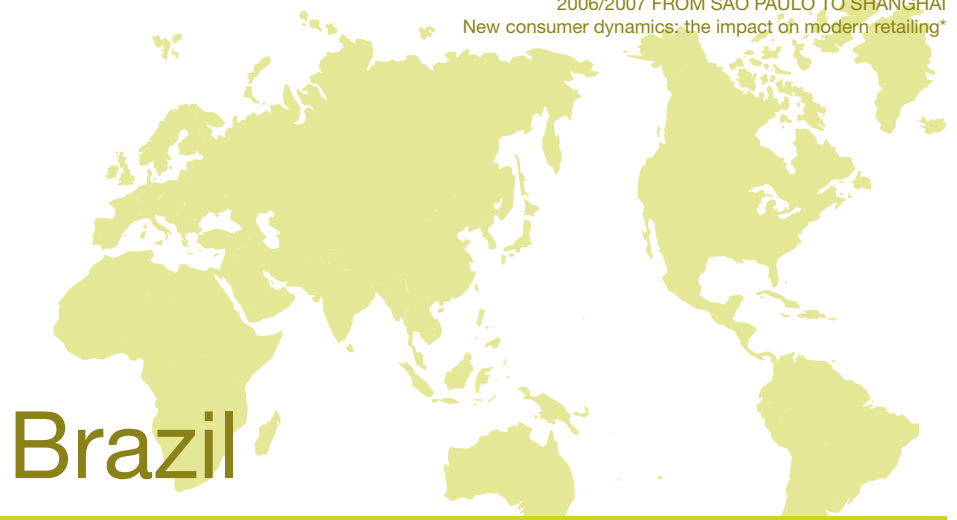
The likelihood of the new President (to be elected in October 2006) carrying out political, tax and pension reforms at the beginning of the mandate will be decisive to getting sustainable and higher economic growth rates. A gradual decrease in the interest rates, already in place, will also be important to improve the domestic consumer market and to push investment incentives in the private sector.

Externally, as soon as some domestic indicators show improvement and Brazil gets an investment grade rating, a strong inflow of direct foreign investment in the economy is expected.

Key economic forecasts

	2006	2007	2008
GDP growth (%)	3.4	3.3	3.6
CPI (%)	4.7	4.5	4.4
Unemployment rate (%)	9.7	9.6	9.1

Source: EIU, July 2006



Brazil

FOREIGN DIRECT INVESTMENT

Boosting foreign direct investment

REGULATORY ENVIRONMENT

An attractive regulatory environment

Brazil has historically been one of the preferred countries for foreign investors as registered capital and earnings may generally be repatriated on a tax-free basis. After some years of relatively low inflow level, foreign direct investment (FDI) is now on the upswing, reaching USD18.3 billion in 2004. The upgrade to investment grade level will probably boost FDI in Brazil, ranking the country amidst the three most favoured FDI destinations in the world¹.

Retail and consumer, and particularly the Food & Beverage segment, was the most attractive sector for FDI in Brazil in 2005, with more than USD5 billion invested². In this complex, sizeable and diversified economy, opportunities often rise for strategic and financial investors. Strategic players have definitely prioritised the Brazilian market as core in their global presence, independently of whether they are large corporations or medium-sized companies. On the financial investor side, private equity funds have significantly increased their participation in the market, particularly through those companies with high potential to be attractive in an initial public offering (IPO).

FDI

	2002	2003	2004	2005
FDI (BRL bn)	48.5	31.2	53.1	37.0
FDI (USD bn)	16.7	10.1	18.3	15.6

Source: EIU, July 2006

PROPERTY/REAL ESTATE REGULATIONS

Few restrictions on foreign ownership

Currently, the Brazilian property market is very attractive for both, local and foreign investors. In general, local or foreign investors are welcome and treated equally as regards investments incentives or tax concessions. Very few restrictions are imposed on foreign ownership, except, for instance, for national security reasons in the areas of defence and communications.

¹ Brazil Business magazine
² Central Bank of Brazil



Brazil

Major global retailers and consumer products manufacturers have entered and expanded their operations in the Brazilian market, mainly through acquisitions, followed by organic growth by opening new stores, logistic parks, or industrial plants. Any company properly registered under Brazilian laws may acquire real estate essentially without any limitations.

Despite a considerable list of bureaucratic requirements and complex tax and labour codes, normally no significant obstacles are encountered for running a business in Brazil. However, special attention must be given to those activities or situations in which some important environmental impact can be caused. In-depth assessment reports are normally required and months can be spent in the process of getting the permits.

A property transfer tax of up to 6% is payable by the acquirer on sales or transfer of real estate. An annual real estate tax of 0.2% to 5% is levied on the assessed fair market value of the property.

OTHER REGULATIONS

Competition law and consumer protection

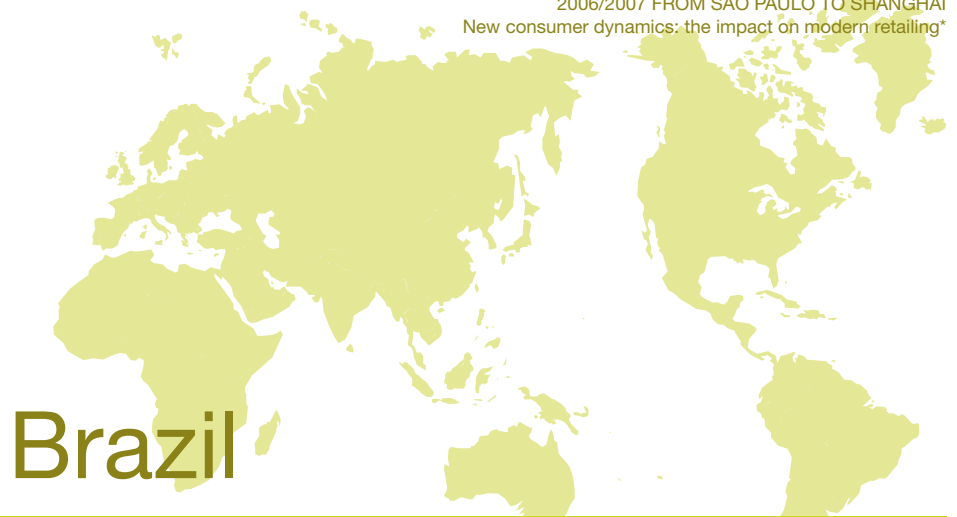
The Administrative Council for Economic Defence (CADE), a government agency, is responsible for investigating and suppressing unfair business practices and anti-trust monitoring. The Antitrust Law (Law 8884/94) contains wide-ranging regulations in defence of free-market competition.

There are specific agencies concerned with standards, quality and supply of foodstuffs, including imported products and regulations on weights and measures that must be observed by the consumer products sector. The Consumer Code Defence considerably strengthens the rights of customers.

TAX AND VAT

The Brazilian tax system is highly regulated and extremely complex. Different taxes/rates on the federal, states or municipalities levels have become a key theme in all sectors and for most companies that operate in Brazil.

Despite no specific tax being additionally imposed in the retail and consumer sector in Brazil, the tax implications in the supply chain management are definitely crucial to determine the level of profitability and competitiveness for most of the companies.



Corporate Income Tax

The main direct and indirect taxes applicable in Brazil are:

Corporate income tax (IRPJ) is charged at the rate of 15% plus a surcharge of 10% on annual taxable income in excess of BRL240,000 (approximately USD109,000). Additionally, a social contribution tax on profits (CSSL) is applicable at the rate of 9%.

Social Integration Programme Tax (PIS) and Social Contribution on Revenues (COFINS)

PIS and COFINS (generally levied at 1.65% and 7.6%, respectively), are federal contributions calculated as a percentage of gross revenue. Newly enacted PIS/COFINS credit systems are meant to ensure that tax is applied only once on the final value of each transaction. As from May 1, 2004 the PIS/COFINS contributions apply also on the imports of goods and on the payment of services to non-residents, while exports are exempt.

Federal VAT (IPI)

This federal valued-added tax is levied at varying rates around 10-15% on nearly all sales and transfers of products industrialized in or imported into Brazil. Exports are exempt.

State VAT (ICMS)

State VAT is levied on sales or physical movement of goods, on freight transportation, communication services and electric energy. The usual rate is around 17-19%, but some products trigger an exceptionally higher rate (usually 25%) or a lower rate. Exports are also exempt.

STORE OPENINGS

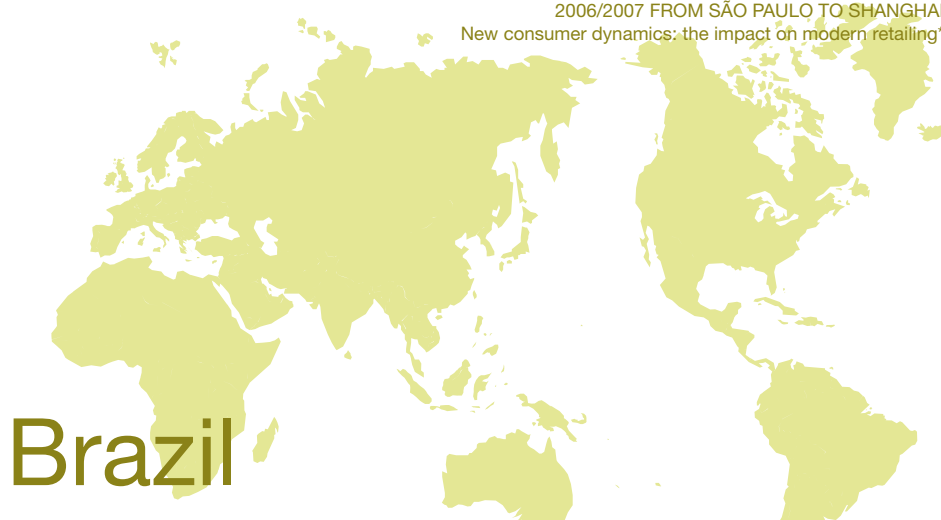
Retailers are free to set opening hours at their sole discretion. Many retailers operate on a seven day week basis and some of them on 24-hours a day.

IMPORTS

For many years, local industry was protected from imports and the overall tariff burden was high.

However, over the last years import duties and trade barriers have been gradually reduced and imports of various products are encouraged when local prices are higher than international prices or when there is a shortage of local products. Import tax is levied on the CIF price and is a non-deductible cost. The rate depends on the degree of necessity and is defined by the product's tax code.

Other taxes like IPI, PIS, COFINS and ICMS are normally levied on imports and are generally applicable to the value-added by each company.



POPULATION EVOLUTION

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

The largest population in Latin America

With over 181 million people, Brazil ranks as the sixth largest in the world and the largest in the region. Population is estimated to be growing at approximately 1.3% per year.

Population

	2002	2003	2004	2005
Population (m)	176.4	176.8	179.1	181.4

Source: EIU, July 2006

All Brazilians speak Portuguese; English is the foreign language most used by the business community.

The majority of Brazilians are of European or African descent. Apart from the original Portuguese settlers, others who have settled in Brazil and significantly influenced its culture include Germans (mainly in the southern states), Italians and Japanese (mainly in the state of São Paulo). In the larger cities, there are many other smaller ethnic communities representing most nationalities. There are also some sparse indigenous tribes in the Amazonian regions.

POPULATION BY AGE GROUP

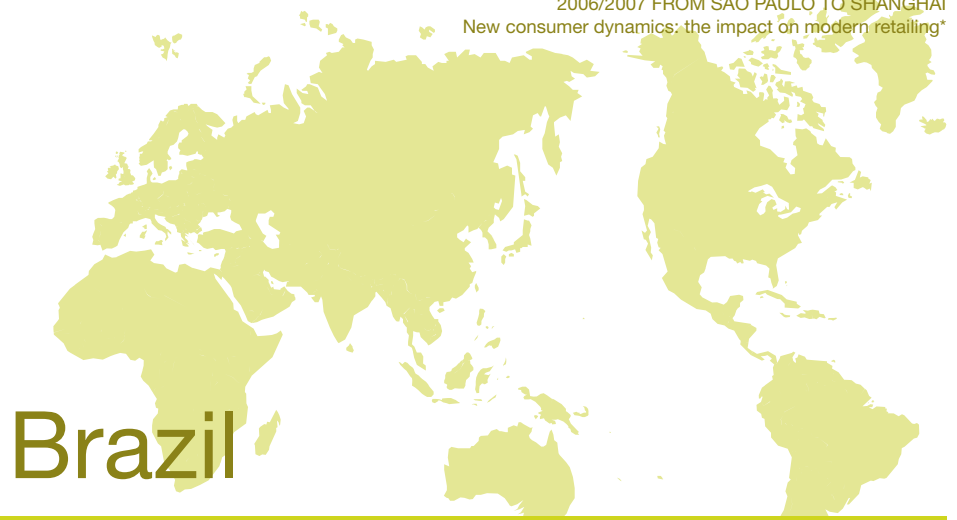
A significantly young population

About 42% of the population is under 20 years of age and less than 7% is over 65. The average life expectancy is 69 years.

Age profile

% of total population	1998	2003	2008 (f)	Trend
0 – 14 years	29.3	26.6	24.5	↓
15 – 64 years	65.5	67.6	68.9	↑
Over 65 years	5.2	5.8	6.6	↑

Source: EIU, July 2006



Brazil

URBANISATION OF THE POPULATION

A polarized urban population

More than 80% of the population in Brazil is urban and approximately 30% live in the ten principal metropolitan areas. The metropolitan areas of São Paulo and Rio de Janeiro have populations of around 19 million and 12 million, respectively. Some 14 other metropolitan areas have populations of more than 1 million. The population growth is fairly evenly spread over all regions, but the North and Centrewest are expected to grow at faster rates.

Urban/Rural split

% of total population	1999	2004	2009(f)
Urban	80.5	83.5	86.1
Rural	19.5	16.5	13.9

Source: EIU, July 2006

INCOME/BUYING POWER

Rising incomes

Income per capita in Brazil has increased during the past years and is expected to continue to grow in the medium term, as a result of the expected economic growth.

Population Distribution by Area and GDP

Region	GDP per capita (BRL)
North	4,939
Northeast	3,694
Southeast	10,086
South	9,157
Centrewest	8,166
Total average	7,704

Source: Instituto Brasileiro de Geografia e Estatística 2002/ no updated information available

GDP per capita varies from BRL3,694 in the Northeast to BRL10,086 in the Southeast. Purchasing power is also expected to grow as a consequence of the decrease in the interest rates and of credit expansion – the latter, as a result of partnerships among financial institutions and the main retail players.

Income concentration is still a challenge for the Brazilian governments. Data from the World Bank point to a decline in the Brazilian income inequality and poverty levels from 1993 to 2004.



Brazil

A growing middle class

CONSUMER BEHAVIOUR

No coherent consumption pattern

According to research conducted by Instituto Target/FGV, in the next 5 years the Brazilian middle class is expected to grow its share in the consumer market by 5.6 points, from 60.8-66.4% of the total consumption. For this research, middle class is defined as having household/family income between BRL2,230 and BRL3,750 per month, in addition to other characteristics such as level of education, consumption pattern, occupation, etc.

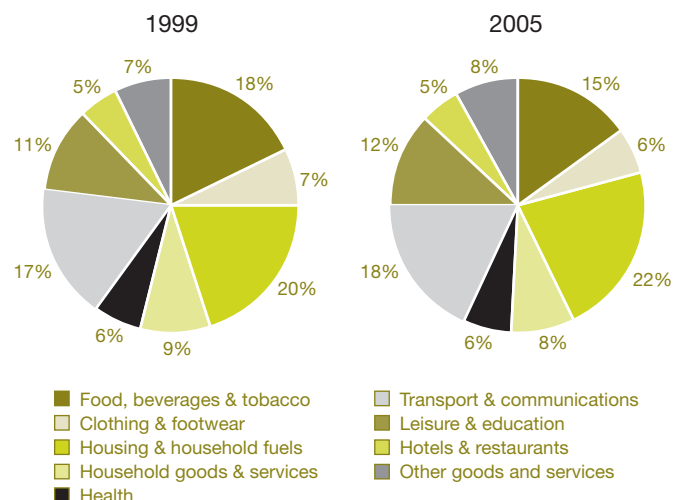
The number of urban households among middle class is expected to increase by 7.9% over 2005 (which amounts to 2.04 million units).

Despite the fact that 80% of the Brazilians live in urban areas, this apparent uniformity does not reflect homogenous consumption habits.

As mentioned before, as a result of a historical inequality in income distribution, different classes of consumers are encountered in the Brazilian consumer market, like for instance, the typical basic needs patterns in lower income classes, where household spending is higher on food and beverage items, or the ascendant middle class pattern that normally shows an increase in the participation of expenditure in transport and communications. Upper classes reveal an increase in the share of goods and services, like durable goods, leisure activities, education and healthcare, and expenditure with luxury items.

The main retail and consumer players currently target each of these groups in the Brazilian consumer market, as long as they are sizeable and have a significant consumption potential likely to grow both in volume and value.

Composition of average household expenditure: 1999 vs. 2005





Brazil

LIFESTYLES/ SHOPPING HABITS

*Shopping for leisure in
urban areas*

BRAND/PRICE SENSITIVITY

*Well-developed brand
awareness*

Consumer behaviour has ceased being stable since globalisation, communication and internet have played an important role in consumer habits. In Brazil, trends connected with the principles of “quality of life”, convenience, price-consciousness, brand loyalty and others are very present in the market.

In fact, many companies in Brazil already provide products and services that meet the consumer needs derived from those trends. For instance, Nestlé has announced another new unit in the North of the country, for the demand of the lower income (C/D/E) classes, which will probably include the development of new products to meet their specific needs.

Shopping is definitely integrated into the lifestyle of the Brazilian urban population, as an usual and necessary activity and as an entertainment programme.

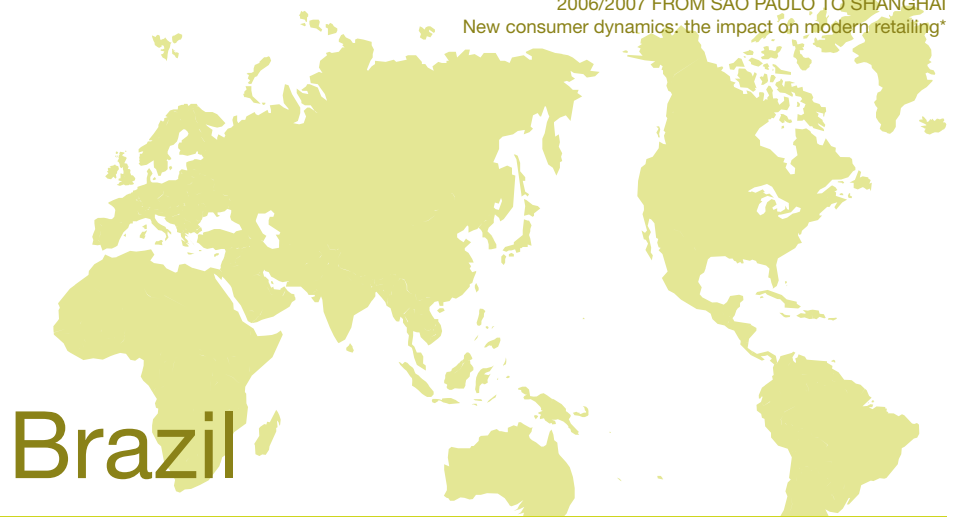
Shopping malls, outlets, hypermarkets, supermarkets and convenience stores have been designed to fit the profile of the relevant customer. Regardless of whether the consumer's profile is of high or low consumption, quality-service or price-oriented, or attracted to branded or private labels, in most developed cities it is possible to find places that best meet these characteristics.

Many of these places are designed to offer a wide range of services (for example, restaurants, coffee shops, fitness centres, beauty parlours, shoe repairs, post offices, bank services and dry-cleaners among others) and to provide some entertainment with cinemas, cyber-café and play areas for children.

The Brazilian consumers distinguish products by the brand, associating them with concepts of high quality, trust, loyalty and status. The Brazilian consumer market has plenty of examples of local or international brands that have historically maintained a significant market-share.

Despite the fact that Brazilian consumers recognise distinct brands, they are influenced by those brands in their purchasing decisions, and eventually contribute as opinion makers to attract new consumers to the brands, it is important to point out that there has been a real increase of price-conscious customers in Brazil.

Large retail chains have been decisive in stimulating this consumer behaviour, through an aggressive implementation of discount format stores and by expanding the portfolio of private label products.



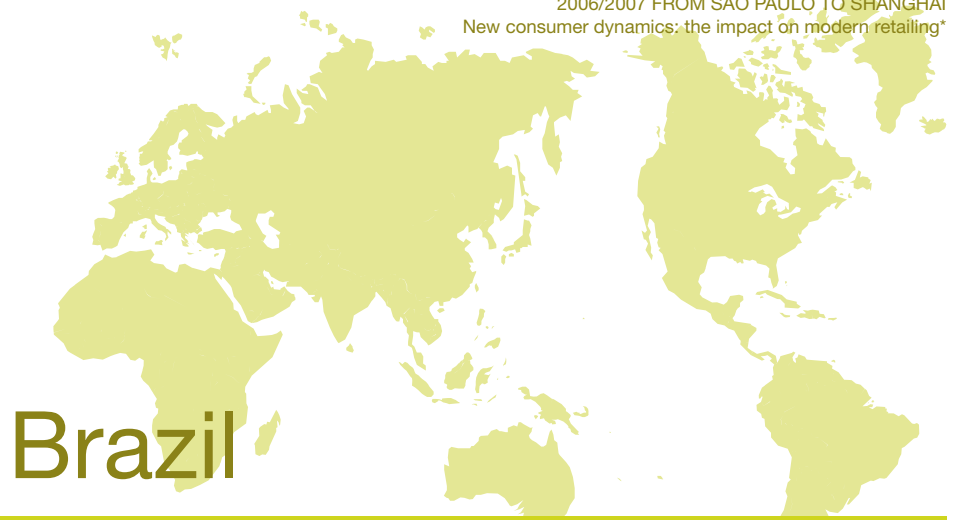
MAJOR CONSUMER GOODS PLAYERS

RETAIL AND CONSUMER SECTOR PERFORMANCE

Most consumer goods production segments in Brazil have a significant presence of multinational companies. Historically, the major consumer goods players have invested in their growth through acquisitions of local operations or competitors that own leading domestic brands, in addition to their organic expansion. Some of these global companies today have lengthy experience of doing business in Brazil.

Key consumer goods companies

Company name	Category	2005 Gross Sales (USD m)	Controlling Shareholder
Ambev	Beverages	12,343	Belgian
Cargill	Food	5,896	American
Bunge Alimentos	Food	5,324	Bermudan
Nestlé	Food	3,575	Swiss
Sadia	Food	3,559	Brazilian
Souza Cruz	Tobacco	3,404	British
Brasmotor	Home Appliances	2,735	American
Perdigão	Food	2,510	Brazilian
Unilever	Food	3,850	British
Friboi	Food	1,756	Brazilian
Avon	Cosmetics	1,710	American
Louis Dreyfus	Food	1,656	French
Natura	Cosmetics	1,386	Brazilian
Schincariol	Beverages	1,329	Brazilian
Coca-Cola	Beverages	N/A	American
Kraft Foods	Food	1,318	American
Samsung	Electronics	1,302	Korean
Elma Chips	Food	973	American
Coamo	Food	1,160	Brazilian
Avipal	Food	969	Brazilian
Johnson & Johnson	Personal Care	850	American



Brazil

Company name	Category	2005 Gross Sales (USD m)	Controlling Shareholder
LG	Electronics	847	Korean
Semp Toshiba	Electronics	807	Brazilian
Kaiser / Femsa	Beverages	775	Mexican
Aurora	Food	750	Brazilian
Doux Frangosul	Food	718	French
Coteminas	Textiles	734	Brazilian
Vicunha	Textiles	714	Brazilian
Caramuru	Food	713	Brazilian

Source: Exame Melhores e Maiores, Balanço Anual Gazeta Mercantil

Although there are some multinational companies with relevant market-share, there are also important local players in certain market segments who lead regional consumer goods companies, with strong brands, modern manufacturing facilities, in-depth knowledge of consumer preferences and well-customized distribution.

The market concentration process that has taken place in the Brazilian retail market over the past years has helped larger consumer manufacturing goods companies, since they are in a better position being large scale suppliers.

Brazilian companies like Sadia, Perdigão, Ambev, Bertin and Friboi in the food and beverage sector, and Natura in the personal care and cosmetics products sector, have also expanded overseas through exports or the opening of subsidiaries abroad, and so have prepared themselves to compete against other multinationals in different countries.

Food and beverages

An expanding food and beverages sector

According to the Brazilian Food Industries Association (ABIA), this sector expanded by 4.7% in 2005, obtaining revenues of BRL184.2 billion and accounting for 9.5% of GDP. The beverage segment showed a strong expansion of 8.9% in comparison with 2004, with total revenues of BRL25.7 billion.

In 2005, Brazil retained its leading position as one of the largest meat exporters, being the first in the bovine meat segment, the second in poultry and the fourth in pork.



Brazil

In addition to the strong competitiveness of Brazil as a food producer, its domestic market offers huge growth potential. A very significant contingent of potential consumers has currently not attained the minimal levels of consumption and any increase in the income of this group will likely boost demand, particularly in this industry.

This growth perspective has attracted financial and strategic investors such as AIG, Nestlé, Cargill, Ambev and Coca-Cola. Most of them are interested in strengthening their market position, adding production capacity or are even looking for opportunities for geographic consolidation.

In fact, there still are a significant number of companies in the second-tier, most of them facing succession issues and needing to step-up revenues to become sizeable in a market that is in the process of concentration. Limited resources for cashing-out to shareholders and cashing-in for capital and marketing expenditure creates room which is favourable to strategic and financial investors.

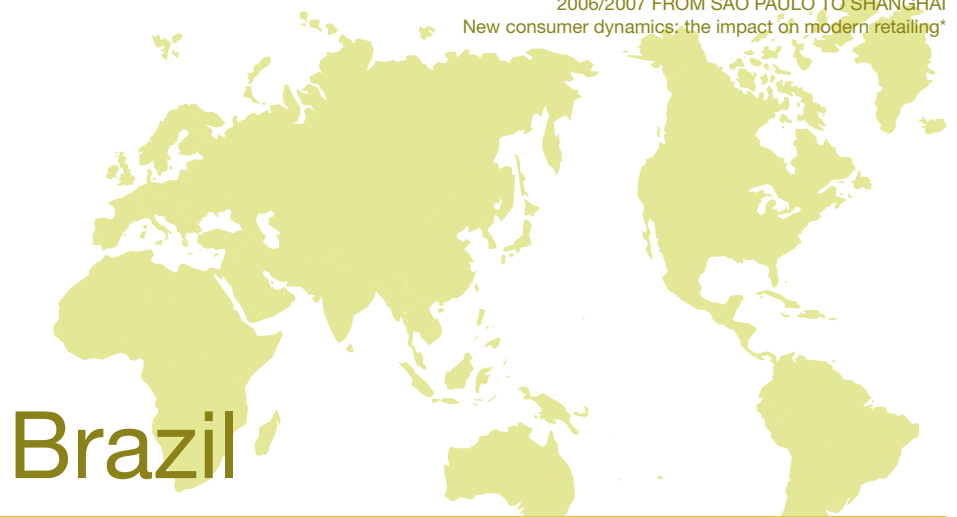
Multinational companies are market leaders or relevant players in segments such as beer, soft and alcoholic drinks, tobacco and confectionery.

Brazil's beer market is the fifth largest in the world and produces more than 9 billion litres in 2005. Ambev is the major company with a market-share of around 68%, followed by Schincariol which accounts for approximately 13% of participation.

The Brazilian soft drinks market is the third largest in the world, with a production of around 12 billion litres in 2005. Coca-Cola and Ambev (which produces and distributes Pepsi locally) topped the rank of producers representing more than 70% of the market.

The ready-to-drink juice market has shown a two-digit yearly growth rate since the Mexican company Del Valle started local operations in 1999. Motivated by changes in the consumer behaviour that are connected with healthier food and beverage habits, many companies in this industry have been launching their own product lines or even acquiring established operations and brands, like Coca-Cola did when they acquired Sucos Mais in 2005.

Also in the confectionery market, Brazil appears as one of the largest in the world, being second in the candies segment and fourth in chocolate. Total production in 2005 (including exports) was estimated at BRL8.5 billion, with chocolate products accounting for BRL5.6 billion. Major multinational companies are Nestlé and Kraft Foods.



Cosmetics and personal care

A promising cosmetics and personal care market

Brazil is the fourth largest cosmetics and personal care market in the world. In 2005, revenues increased by 14.1% in comparison to 2004 and were over BRL15.3 billion. The real compound annual growth rate in the period of 2000 to 2005 was 10.7%, which is quite impressive when compared with the modest Brazilian average GDP annual growth rate of 2.2% in that period.

The growing participation of women in the labour market and the increase of life expectancy have brought about a new pattern. The necessity to maintain a wealthy and youthful appearance have stimulated producers to launch new products focused on these new demands and to invest heavily in process and development technologies, increasing productivity and allowing price reductions. The diversity of the Brazilian natural forests has been increasingly a source of inspiration and supply to this industry which has just started exports based on products developed from oils and essences extracted from exotic plants.

The Brazilian cosmetics and personal care market is consisted of 1,367 manufacturers, of which 15 are large companies with revenues of over BRL100 million, accounting for 71.7% of total revenues. The traditional distribution channel is predominant although door-to-door and franchising channels are also used.

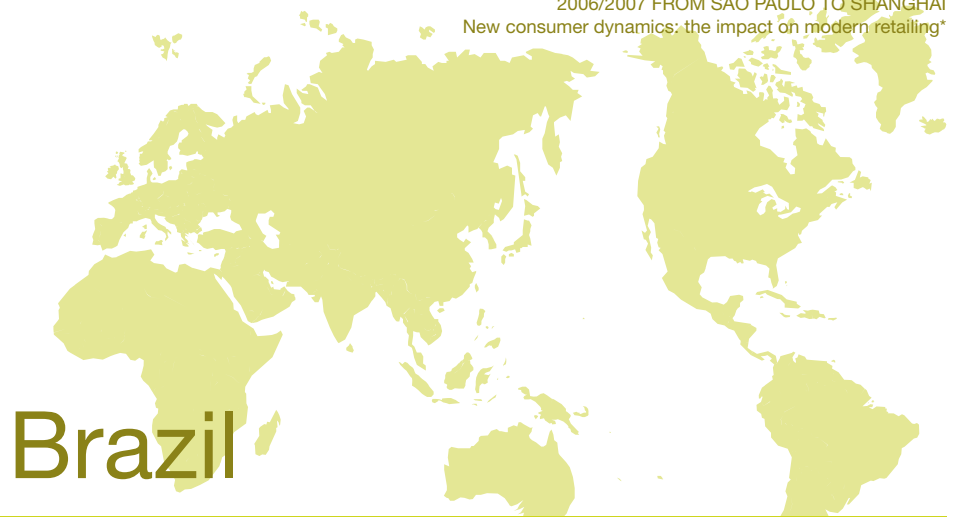
Multinational companies like Unilever, Avon, Colgate-Palmolive, Johnson & Johnson, Procter & Gamble and BDF Nivea, among others, account for the most representative market-share. However, some important local players like Natura and Boticario also have very significant presence even being niche or regional market leaders.

Electronics

A well developed base for electronics

The Brazilian electronics and home appliances market recorded sales of around BRL16 billion in 2005, an increase of 5% over 2004. With a locally well-installed industry base, predominantly formed by multinational companies like Philips, LG, Whirlpool, Samsung and others or Brazilian companies such as Semp Toshiba and Gradiente, most products are manufactured or assembled locally.

The Brazilian home appliances sector has different levels of market saturation depending on the product, for instance, stoves show the highest rate of saturation, 98%, followed by video and audio equipment and refrigerators at around 90%. Washing machines, freezers and microcomputers have lower rates of saturation, between 20-30%.



Clothing and shoes
*A strong clothing and shoes
segment*

MAJOR RETAIL PLAYERS

Retail Sales

Brazil is the third largest footwear producer and the fifth largest footwear market in the world in volume terms. The clothing industry is also strong and competitive and the presence of local brands and manufacturing plants is significant.

Companies like Vicunha, Coteminas, Alpargatas, Grendene, among others, have in fact steadily increased their domestic and foreign sales.

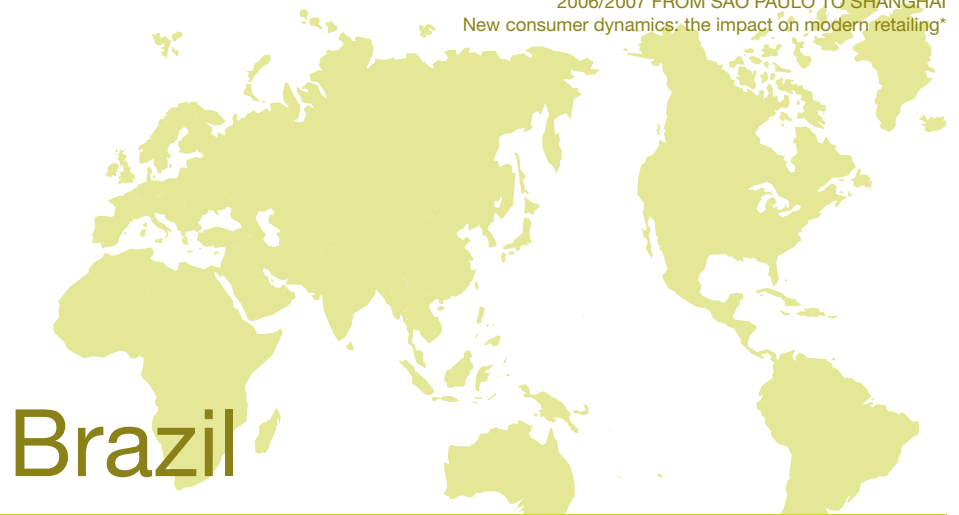
The Brazilian retail industry grew by around 9% in 2005 with food retail increasing by 7.8% over the previous year. E-commerce continued to climb, despite its small participation in the total retail market, reaching BRL9.9 billion, up 32% from 2004, influenced mainly by the sales of audio and video equipment.

Retail sales growth

	2003	2004	2005
Retail sales (USD m)	155,273	180,933	237,662
Retail sales growth (% pa in BRL)	-2.3	3.9	2.3
Retail sales: food (USD m)	85,940	99,282	129,302
Retail sales: non-food (USD m)	69,333	81,651	108,360

Source: EIU, July 2006

Large retail companies are actively looking for new expansion opportunities and were involved in acquisitions, such as the purchase of the supermarket chain store, Sonae, by Wal-Mart.



Brazil

Top 15 retailer companies

Company name	Major category	2005 Gross Sales (USD m)	Controlling Shareholder
Companhia Brasileira de Distribuição	Food retailer	6,890	French-Brazilian
Carrefour	Food retailer	5,098	French
Casas Bahia	Specialty store	5,078	Brazilian
Wal-Mart	Food retailer	4,226	American
Makro	Food retailer	1,665	Dutch
Ponto Frio	Specialty store	1,652	Brazilian
Atacadão	Food retailer	1,389	Brazilian
Lojas Americanas	Food retailer	1,170	Brazilian
Grupo Martins	Food wholesaler	1,165	Brazilian
Casas Pernambucanas	Specialty store	1,130	Brazilian
Lojas Riachuelo	Specialty store	921	Brazilian
Magazine Luiza	Specialty Store	747	Brazilian
Insinuante	Specialty Store	683	Brazilian
Renner	Specialty Store	657	“pulverized”
D Paschoal	Specialty Store	654	Brazilian

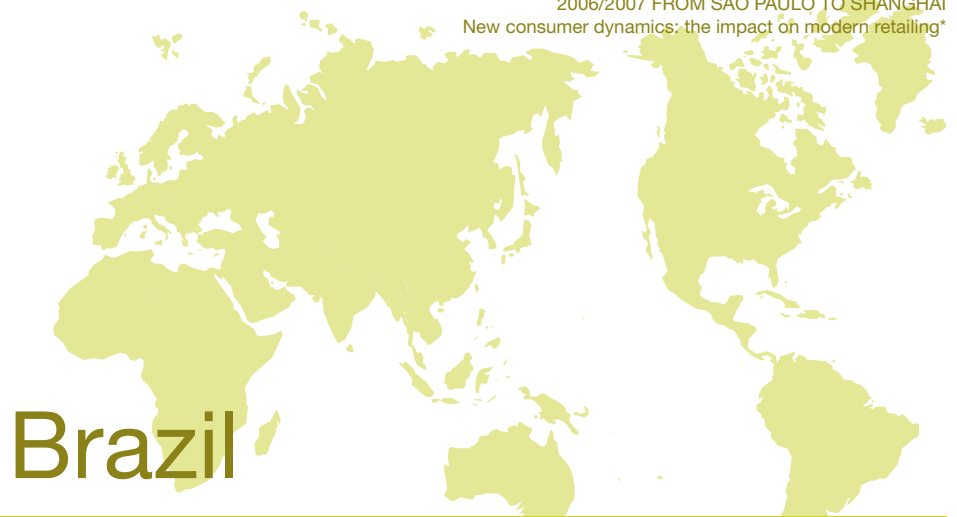
Source: Exame Melhores e Maiores

Food retail channels

Market-share by retail formats (%)

	Hypermarkets	Supermarkets	Convenience stores
2005	39	60	1
2004	56	43	1
2003	44	55	1

Source: ABRAS; AC Nielsen



Brazil

Major food retailers

Ranking	Group name	Store brands	Store formats	Number of stores
1	Cia. Brasileira de Distribuição	Pão de Açúcar, Extra, Compre Bem, Sendas	Supermarket Hypermarket	556
2	Carrefour	Carrefour	Supermarket Hypermarket	390
3	Wal-Mart	Wal-Mart, Sam's Club, Bompreço, Big, Nacional, Mercadorama	Supermarket Hypermarket Discount store	294
4	Cia Zaffari	Zaffari, Bourbon	Hypermarket	26
5	DMA Distribuidora	Epa, Mart Plus, Via Brasil, Via Atacado	Supermarket Hypermarket	63
6	G. Barbosa Comercial	G. Barbosa	Supermarket Hypermarket	32
7	Irmãos Bretas, Filhos e Cia.	Bretas	Supermarket Hypermarket	42
8	Cooperativa de Consumo	Coop	Supermarket Hypermarket	22
9	A. Angeloni & Cia	Angeloni	Supermarket	19
10	Irmãos Muffato & Cia	Muffato	Supermarket Hypermarket	17

Source: ABRAS

Supermarkets
Strongest by number

The supermarket segment captures approximately 80% of the market estimated at around 72,000 stores. Companhia Brasileira de Distribuição, Carrefour and, more recently, Wal-Mart, have a wider geographic coverage over the main cities across the country.

The concept of the neighbourhood supermarket has been improved upon by the larger chain stores through information technology and management retail techniques which help to identify customer profiles, thereby permitting an adequate customisation of the stores and maximisation of client satisfaction. In fact, many of these neighbourhood supermarkets are already mixing



Brazil

convenience stores format principles. There are also a large number of local players with a significant presence in their regions which have rapidly improved their operations, opened new stores and started to work with new retail formats.

Martins, a well-known wholesaler in Brazil, has developed its own model to increase sales, through a wide program of training small and medium-sized retailer operators. Martins Retail & Distributive Trades University has developed products and services with the objective of disseminating knowledge to strengthen and modernise small and medium-sized retail trade. Through different means, the institution provides on-site and distance training for its sales force and for clients from different areas, developing store modernisation projects which include layouts, refreshing assortment and management support tools.

Hypermarkets *Strongest by sales*

The hypermarket format is very well-disseminated in Brazil, ranking in the top position in sales, and is particularly strong in the big cities, where there is still demand for new stores. The largest international or local retailers have led the development of the hypermarkets and are now entering into a new phase.

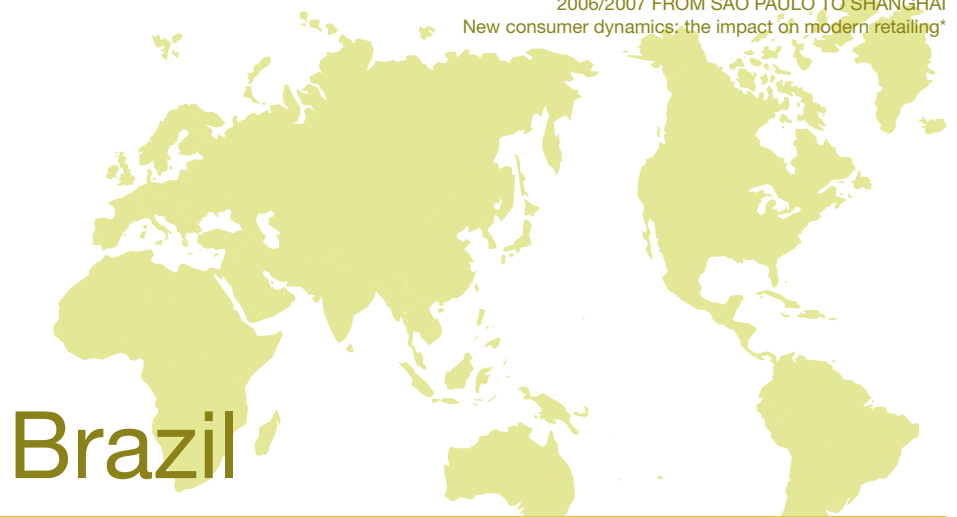
Non-food segments, such as clothing & footwear, are on the rise as good opportunities for increasing sales and profitability. In the food segment, private labels are an important drive to assure quality and to offer competitive prices. Private label products are largely found in the clothing chain stores. At the same time, there is a growing tendency in hypermarkets to offer services which include finance, leisure, and travel, among others.

Convenience stores *Hybrid indigenous format*

Large retailers already understand the concept of convenience in the retail industry instead of a format retail option.

Available statistics about convenience stores only cover the 3,100 odd stores located in gas stations, which represent around 0.4% of total sales in the Brazilian retail industry. However, the concept of convenience is a local reality through a wide range of hybrid formats that include outlets ranging from small independent supermarkets to bakeries. If the latter were considered as convenience stores, the format would show a different market-share.

Pharmacy and drugstore chains are also highlighted as strategic convenience stores, as they are prepared to expand their activity adding more items of convenience.



Brazil

Non-food retail channels Speciality stores

Credit expansion has been an important driving force for revenue in 2005 for many of the non-food retailers in Brazil. Following the trend of creating partnership or similar associations with financial institutions, retailers have in fact received an injection of capital that has been used to expand operations, through the opening of new stores and the acquisition of small competitors.

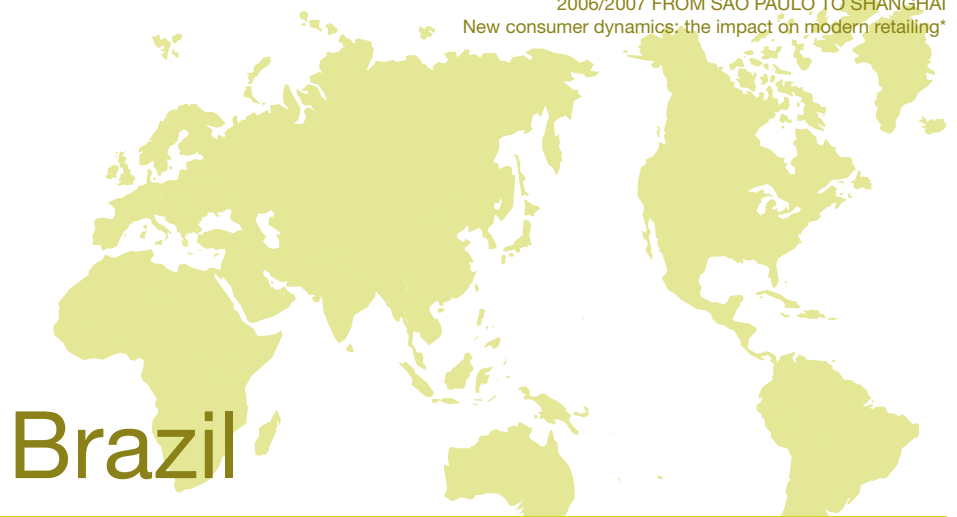
In addition, these partnerships have increased the number and amount of financed sales. From the financial institutions' viewpoint, the partnership has been a quick way to obtain a mass of potential clients for other financial services, such as personal credit lines, insurance, credit cards among others.

Major specialty stores

Group name	Store brands	Store formats	Number of stores
Casas Bahia	Casas Bahia	Home equipment & furniture	500
Ponto Frio	Ponto Frio	Home equipment & furniture	369
Lojas Pernambucanas	Pernambucanas	Department store	238
Lojas Riachuelo	Riachuelo	Department store	79
Magazine Luiza	Magazine Luiza	Home equipment & furniture	350
Insinuante	Insinuante	Home equipment & furniture	150
Lojas Renner	Renner	Department store	72
DPaschoal	DPaschoal	Tires & accessories	200
Lojas Colombo	Colombo	Home equipment & furniture	360
Drogaria São Paulo	Drogaria São Paulo	Drugs & Pharmacy	185

Source: Gazeta Mercatil, Company's websites

The reduction of interest rates, combined with a potential increase in the purchasing power of the population as a result of the sustainable growth of the economy, have attracted financial investors interested in the retail sector, such as the Capital Group, which acquired a stake in Magazine Luiza.



E-commerce

The construction materials, home decoration and furnishing market has also expanded and chains like Leroy Merlin, C&C and Telhanorte have aggressive plans to increase the number of stores in the first and second tier cities, stimulated by the recovery of real estate growth and the increase in the number of apartments and residential housings.

According to analysts, e-retailing revenues in 2006 are expected to reach BRL14 billion, an increase of 41% over 2005. The largest internet retailer in Brazil, Americanas.com recorded revenues of BRL864.8 million in 2005, an increase of 99% over 2004.

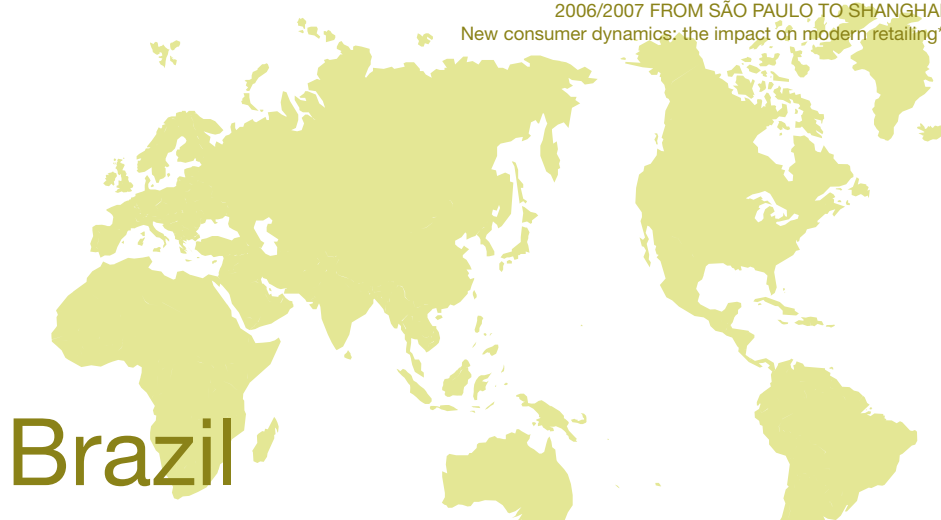
The number of internet users in 2006 is estimated at 15.7 million, an increase of 16.4% or 2.2 million people, according to Ibope Net Ratings. But analysts estimate the number of potential internet users at 70 million people. Attracting these users is key to boosting e-commerce sales. The confidence in the payment system is an important part of this attraction process and initiatives like e-shopping through mobile phones are perfectly aligned with the concepts of mobility and agility intrinsically connected to internet.

M&A activity

The first half of 2006 has shown an important reaction in the mergers and acquisitions (M&A) activity in Brazil. The number of deals in this period was 35% higher than in the same period of 2005, with 241 transactions against 178 in the first semester of 2005. The record was 321 transactions in the same period of 2000 which was however affected by a significant number of small e-business related transactions.

This increase in the number of deals was expected since financial and corporate investors have realigned their investments; industries have concentrated and consolidated in search of synergy; private equity funds, both existing ones and new entrants, have made new investments, but there have also been some exits; new strategic players have entered the Brazilian market; and the economy continues to show signs of future growth and is expected to attain the investment grade level.

The breakdown of the transactions has shown that sectors such as IT, food and beverage, chemical and petrochemical and financial institutions have historically been positioned between those which show a higher number of deals. Together, these sectors have normally accounted for 35-45% of the total number of transactions.



Brazil

Retail and consumer sector

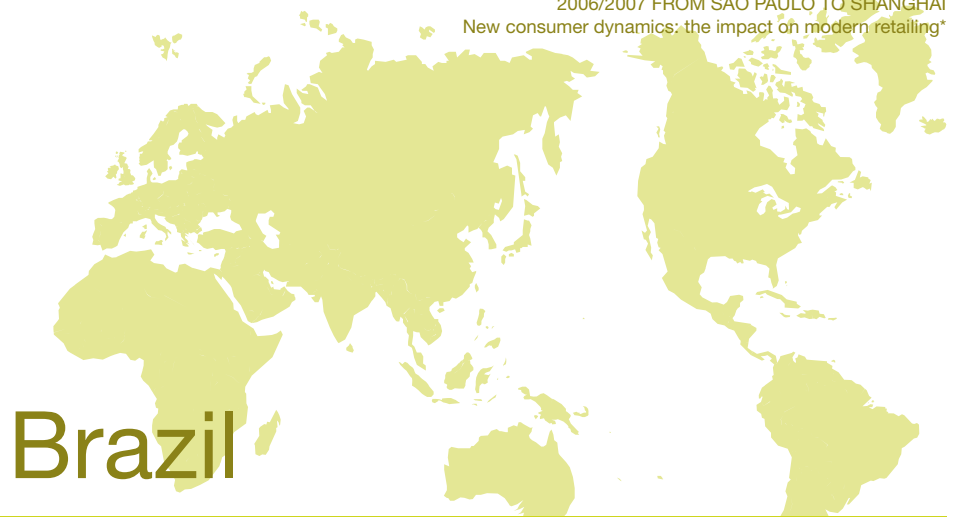
Food and beverage and retail sectors have accounted for 54 deals in the first half of 2006, which is almost equivalent to that for the whole year of 2004 with 56 transactions, and represents 70% of the total transactions of 2005 in these sectors.

The transactions in the juice segments and between retailers and financial institutions have accounted for the number of the deals in retail and consumer sectors. In monetary terms, the acquisitions of Sonae and Bompreço by Wal-Mart, the transactions between Casino and Companhia Brasileira de Distribuição and the acquisition of Quilmes by Ambev, were valued at BRL3.1 billion.

Major transactions

Year	Acquirer company	Target company	Segment
2006	Bertin	Cooper	Cosmetics & personal care
2006	Ambev	Quilmes	Beer
2005	Casino	Companhia Brasileira de Distribuição	Supermarket
2005	Wal-Mart	Sonae	Supermarket
2005	Capital International	Magazine Luiza	Home equipment & furniture
2005	Coteminas	Springs	Textiles
2005	Assolan	Quimivale	Household cleaning products
2004	Wal-Mart	Bompreço	Supermarket
2005	Coca-Cola	Sucos Mais	Juice
2005	Friboi	Swift Armour	Meat
2005	Cargill	Emegê	Flour mill
2004	Cargill	Seara Alimentos	Poultry
2004	Tereos	Açúcar Guarani	Sugar

Source: PricewaterhouseCoopers Corporate Finance – Brazil



RETAIL AND CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

CHALLENGES

Rising competition

As a result of the concentration process, large international retailers have strengthened their market-shares. Organically expanding through the opening of new stores or the acquisition of other retailer chains, the fact is that an intense development in retail activity is expected in future years, including medium-sized players challenged to enhance efficiency.

Most of the major retailers have announced relevant investment plans which include, in addition to the expansion mentioned above, investments on existing stores, the introduction of new technologies on supply management, marketing and targeting of selected groups of customers.

Reading and connecting consumer patterns

As a result of globalisation and information technology realities, change has become an abiding feature of the retail and consumer industry.

Interacting within this context and also affecting it are the consumers with specific particularities; many of whom are considered to be driving forces which determine trends in the retail industry.

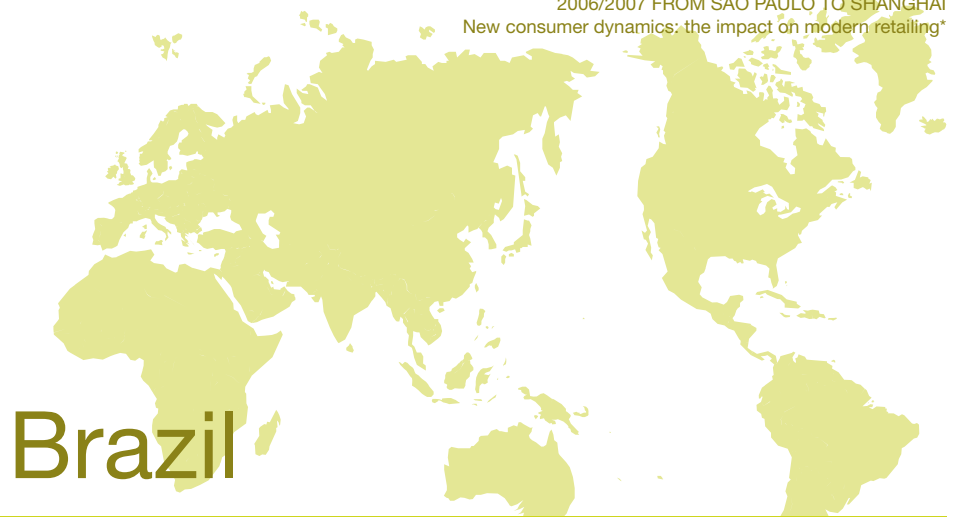
The variety of these consumer groups and habits require the proper response from retailers to address specific customer needs. Being the best and most efficient is no longer enough, as it is also important to be different in order to be part of the customer recognition and connection process.

OPPORTUNITIES

Increasing purchasing power

The perspective of a purchasing power increase based on sustainable economic growth will certainly boost the Brazilian retail and consumer industry. A very significant part of the population which is currently considered to be on the border of the consumption market would have a strong impact on the demand and production levels when it enters this market.

The expansion of credit and the decrease of interest rates are both fuels for the consumption market. In terms of volume, the Brazilian consumer credit market is still small in comparison with developed countries. Credit penetration have increased since financial institutions began entering operational agreements or joint ventures with retailers.



Steady growth of shopping centres

Shopping centres have long been a part of the retail landscape in Brazil. Customised to attend to the needs of more or less sophisticated customers, these places normally offer many options of leisure and convenience activities such as cinemas, restaurants, etc.

Some expansion projects are currently in progress in the main cities and new investments are expected to be made in the second and third tier cities, as a consequence of the growth potential consumption.

According to ABRASCE, Brazil has 263 malls, most of them in the main metropolitan areas, with more than 6 million square metres of retail space and 42,363 stores. São Paulo and Rio de Janeiro states account for 134 shopping centres, but 69 of them are located out of the capital cities.

EMERGING TRENDS

Consolidation in the retail and consumer sectors

Consolidation in the Brazilian retail market is expected to continue, although at a lower intensity in food retail, where the share of the top-five retailers is estimated at around 60%. Acquisitions and further concentration is likely to be seen in non-food retail, where large regional domestic players are intensifying the competition and expanding their activities to other regions. The ability to integrate the acquired operations will determine the level of consolidation and how strong these current regional players will be.

A concentration process is also expected to take place in some manufacturing segments of the consumer products sector, such as dairy products, cookies, pasta and coffee among others.

Increase in private labels

In many cases, private labels have been recognised by customers as an effective way of assuring quality. This perception is a remarkable achievement of retailers, since private label products normally offer better levels of profitability.

Private labels in the segments of apparel and accessories have also been a good opportunity to enhance margins, since these categories of products already offer a higher level of profits when compared with food and beverage products.



Brazil

Multiplying retail formats

Retailers in Brazil should be prepared to operate in different or even multiple retail formats as a consequence of the various types of consumers or group of consumers. In addition, the intrinsic concepts of each format should not be considered to be immutable, but instead dynamic, in a constant transforming process, because consumer needs and behaviour are dramatically changing.

Examples are hypermarkets which have expanded non-food products space to the detriment of food categories, and department stores which have expanded or formed grocery areas, reducing apparel or footwear slots.

Convenience, more than a retail format definition, is in fact a synonym of a new pattern of consumers which has been moulded and influenced by big urban centres. Understanding this consumption pattern is likely to lead to the incorporation of the principles of convenience into most of the existing retail formats.

E-commerce should also be seen as wave that cannot be stopped; availing of this opportunity will probably be the difference between survival or submersion.

Case Study I



Companhia Brasileira de Distribuição – A pioneering multi-format retailer

KEY DRIVERS

Increasing competition and a heterogeneous consumer base make Brazil a very challenging market for retailers. Different consumers have different demands and retail success lies in addressing the full range of customer needs at the same time. What are keys to success in this complex environment?

Companhia Brasileira de Distribuição (CBD), well known for one of its brand names – Pão de Açúcar, is the largest retail chain in South America with annual revenues of around USD7 billion. Despite the presence of global heavyweights such as Carrefour and Wal-Mart, it has been successful in maintaining its position as leader through an intelligent multi-format strategy as well as an aggressive habit of acquiring competitors.

A long-standing multi-format strategy

Founded in 1948, CBD's recent history of impressive growth has been underwritten by one of the owners of the company, Mr. Abílio Diniz, an entrepreneur of great prestige in the Brazilian retail industry.

Currently, CBD runs 558 stores in 15 states and 13 logistic distribution centres, covering about 1.5 million square metres of retail space in the main cities in Brazil. It employs around 63,000 people and is present in the daily life of thousands of customers. CBD operates through the following brand names: Pão de Açúcar (185 neighbourhood supermarkets), Sendas (66 neighbourhood supermarkets), Extra (79 hypermarkets), Compre Bem (176 hypermarkets), and Extra Eletro (50 home appliance and electronic goods stores).

As a leading company, CBD has over the past years been in the vanguard of many trends like private label, 24 hours stores, etc. In the 70s it was the first retailer chain to launch the hypermarket format, called Jumbo, in the Brazilian market. At that time CBD's foreign portfolio included supermarkets in Portugal, Angola and Spain.

Growth through acquisitions

The seventies were also marked by the expansion of CBD through acquisitions in various states of the country. In fact, since it started to grow with acquisitions, CBD has never stopped buying out competitors, which was particularly evident when many years later, the Brazilian retail sector passed through its first wave of concentration. This first expansion phase was followed in the 80s by the introduction of new store formats like discount stores, department stores and DIY stores.

Customer service

CBD became a public company in 1995 and was the first Brazilian retailer listed on the New York Stock Exchange (NYSE). In this same year, it launched the first electronic and delivery supermarket in Brazil, bringing to its customers the access and e-commerce reality.

CBD also innovated when it customised its delivery service to the clients who normally "migrate" to the coast zone in the summer vacation period. Connected by phone or internet, clients may save time to rest and get together with family and friends, avoiding overcrowded shopping areas that are not exactly comfortable places in the high season as a result of the high temperature and limited parking zones.

In fact, customer relations have been part of CBD core business and several actions have been taken systematically to improve them. For example, the launch of a private card, promoting meetings with customers, 24 hour opening stores, banking correspondents allowing clients to pay their bills at the store as well as several social responsibility initiatives and sponsoring of cultural and sport activities.

Supply chain management

On the supply management side CBD has been permanently investing and, taking advantage of its sizeable operation, has developed local suppliers that are able to meet its quality specifications and logistic standards. As a result of these procurement procedures, some years ago it launched a programme to develop small and medium-sized local suppliers, making them compliant with exports through Casino, at that stage a minority shareholder of CBD.

Moreover, the partnership with Casino, one of the important global retailers, was also part of CBD's strategy to enhance its investment capacity, open new markets and quickly improve global sourcing opportunities.

Updated information technology systems and communication are of paramount importance to reduce costs and improve the relationship with suppliers, since traceability and agility transactions are of decisive help in this area. Also, in the vanguard of technology applied in retail industry, CBD has been investing on studies and a pilot project on RFID/EPC (Radio Frequency Identification / Electronic Product Code) technology.

Developing credit and consumer purchasing power

Another milestone and pioneer experience of CBD was in financial and credit activities. Traditionally, retailers in Brazil had operated credit for customers through their own developed structure, managed by in-house resources, using financial institutions as a vehicle if necessary.

In 2004, CBD decided to develop a new financial-credit model which would permit focusing on its core business retail activities and at the same time would optimise and enhance the use of its customer base and flow by partnering with a tier-one financial player.

Therefore, the new model was designed to enable the organisation to be able to offer other financial products traditionally unavailable at supermarket chains. Accordingly, the organisation entered into a joint venture with one of the most important financial institutions in Brazil thus connecting the expertise in the development of supermarket retail operations with the know-how of the financial market.

This initiative leverages business for both CBD and the financial institution, improving the retail stores with financial services and increasing purchasing power of CBD clients. A set of corporate and tax structures was developed and eventually allowed an appropriate balance of interests setting up a joint venture between both parties.

After this transaction many other deals were concluded in the Brazilian retail market, involving similar structures and various retailer players in the supermarket, department stores, furniture and home appliance sectors, among others.

Key takeaways

Over the years, CBD has been able to maintain its position as a winner through innovative strategic development that always remains one step ahead of the game. The secret of its success lies in its ability to respond to consumer needs through a variety of retail formats and broad geographic coverage while simultaneously pushing its own growth through external acquisitions and partnerships.

Case Study II



Wal-Mart in Brazil

MAIN FEATURES

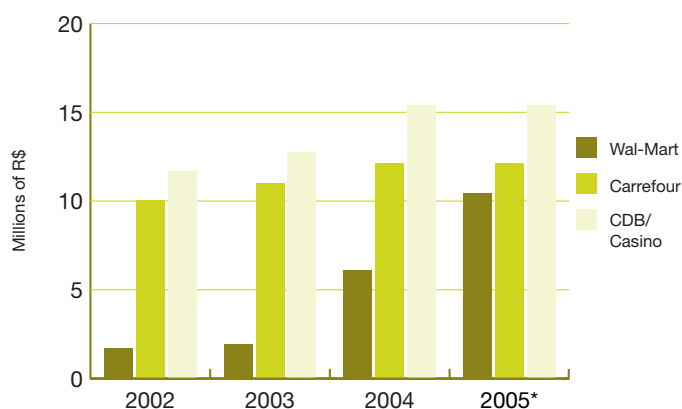
Wal-Mart Stores, Inc., is one of the world's largest retailers, with \$312.4 billion in sales in the fiscal year ending January 31, 2006. The company employs 1.8 million associates worldwide. More than 176 million customers visit Wal-Mart stores worldwide per week.

Wal-Mart has more than 6,200 facilities around the world, including 3,800 stores in the United States, along with 2,400 international units in Argentina, Brazil, Canada, China, Costa Rica, El Salvador, Guatemala, Honduras, Japan, Mexico, Nicaragua, Puerto Rico and the United Kingdom.

Wal-Mart opened its first store, in Brazil, on May 3, 1995; a Sam's Club in São Caetano, in the metropolitan area of São Paulo.

Organic growth

Revenue evolution

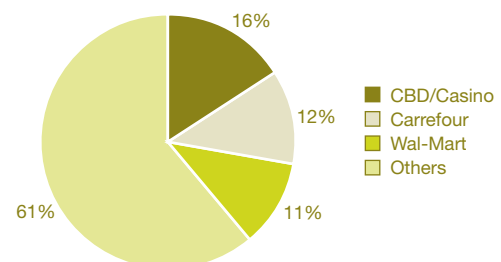


*Estimated figures considering low increase in sales and purchase of Sonae by Wal-Mart

During the first years in Brazil, Wal-Mart grew slowly by adding new locations without any external acquisition. In 1998 Wal-Mart had its first experience of doing business outside the state of São Paulo. A significant breakthrough on Wal-Mart's operations was the opening of the new distribution centre at the end of 2001. Only then was Wal-Mart able to achieve a significant reduction in the operating cost by reaching a critical mass in the number of stores.

Growth by acquisition?

Estimated market share for 2005



61% of the market is still made up of a significant number of minority players who do not make even 2% of market share.

Any attempt to raise market share by any of the main players will require a major acquisition effort of small, regional, niche competitors.

Today Wal-Mart operates 294 stores. In 2004, Wal-Mart Brazil added 118 stores from the Bompreço operation and by the end of 2005, 140 new stores were added from the Sonae operation, being present in 17 out of the 27 Brazilian states.

Local development through sourcing

Wal-Mart procures over 95% of local products. It has developed around 8,000 local vendors in Brazil. It provides training and other assistance to Brazilian suppliers to meet Wal-Mart's quality specifications and eventually makes them compliant with export specifications for the U.S. market, through Wal-Mart's procurement procedure.

Geographical distribution of stores in Brazil



Doing Business in Brazil from a Tax Perspective

Tax burden in Brazil is one of the highest in the world. While the average of the emerging markets is 16% of GNP, the tax burden in Brazil is 38%.

Brazil taxation system is complex, detailed and very dynamic with more than 23,000 changes per year. The legislation is not combined in a unified source, having its laws presented by the federal tax code and several other amendments. The tax law then becomes a dynamic changing document, rather than a static and consistent one.

Additionally, the federation States each have their own tax code based on their legislation. In numerous instances the State tax law is not consistent with the Federal code, creating legal discussions and disputes as to the legality of the laws.

This scenario presents a unique challenge for retailers, as the large product assortments are subject to numerous fiscal requirements that vary from product to product:

- Indirect taxes are embedded in product cost; retailers become tax collectors.

- Complex system to determine applicable tax credits, as this depends on multiple factors such as product type, sourcing, type of buyer, and location of buyer/seller.

Brazilian Corporate Taxes – Quantity of taxes

Number of taxes	Description
52 Federal	5 on revenue, 2 on income, 3 on assets, 6 on imports/exports, 2 on financial operations, 3 on services & goods, 21 on payroll and 10 fees.
13 State	2 on assets, 1 (with 27 different regulations) in services & goods and 10 fees.
30 Municipal	2 on assets, 1 (with over 5,000 different regulations) in services & goods and 27 fees.

There are a total of 95 different taxes of which at least 60 taxes are applicable to current Wal-Mart Brazil operations today.

Tax Project

The challenge

Wal-Mart's corporate systems are known as being the most complete, robust, and to be capable of adding value to the business as no other in the retailing business. Nevertheless, it did not have the capability of dealing with such a complex tax environment as it finds in Brazil. Having the possibility of adding the tax functionality to the existing engine would bring to Brazil all the rest of the functionality that the system already has.

While adding new stores and entering new states created manageable liability, the acquisition of complete chains of stores (Bompreço and Sonae) created an even more significant opportunity.

The challenge was to guarantee that the tax system would fulfill the Brazilian tax legislation and fit the recurrent changes over the years. It would have to be achieved in the shortest time frame and the lowest internal impact possible, knowing that Wal-Mart would have to deal with the largest and most intrusive system change ever endured.

Scope

Wal-Mart team in Brazil has started developing the system specifications and these were translated to programme code by the different focus teams in Bentonville by the Information System Division. This by itself was a task larger than the Y2K and Euro conversion effort put together.

An effort such as this has no means of achieving success if the commitment of all the stakeholders was not present. All main executives in Bentonville¹ have been involved and their participation has had a significant importance. Areas such as legal, tax, information systems, merchandise, vendor relationship and many others have had to act in a coordinated way with their counter parts in-country to deliver a compliant product to the internal customers (users in Brazil).

Once the system was delivered the internal customers had to accept this new code and prepare for the changes the new system forced to the existing processes.

To validate the new code the users developed a series of test scenarios that followed the supply chain process (vendor master, item file, PO creation, merchandise receiving at the distribution centre, store and club, transfers, returns and POS sales).

To prepare for the changes to the process users had to develop training material, communication strategy, help desk infrastructure, plan for contingency and develop an overall implementation plan.

All these tasks were coordinated using project management techniques such as: scope management, risk management, issues management, communication management, quality management and resource management so that all activities were monitored and the productivity was measured.

Outcome

Over 50 users were directly involved working for over 5,000 man/hours during 11 months.

Thousands of POs and Notas fiscais were keyed in, received, transferred and returned to vendors.

128 tax conditions were tested in more than 700 scenarios accounting for more than 90% of all the transaction Wal-Mart currently processes today.

PRICEWATERHOUSECOOPERS ASSISTED IN THIS CASE BY PROVIDING THE FOLLOWING SERVICES:

PricewaterhouseCoopers has been called upon to support the last phase of the systems development effort. The scope of action was concentrated in the following major areas:

- Establish a Project Management Office (PMO)
 - Give support for the project manager, support on project plan elaboration and schedule tracking of overall project and elaborate overall project performance status report.
- System test monitoring and control
 - Support the test leader, track evolution of the test activities, link issues of the system tests and follow up the issues and their evolution.
- Support on implementation plans
 - Support the elaboration of schedule and preparation for implementation plans, provides mentoring and methodology for the following project deliverables: Communication plan, Roll-out plan, Contingency/Fall Back plan and Training plan.
- Perform a quality assurance for test plans
 - Map current processes in order to figure-out combination of processes to be tested, give alternatives and recommendations for processes and align all recommendations given by PricewaterhouseCoopers' tax resources.

¹ Bentonville, Arkansas is the global headquarters (Home office) of Wal-Mart Stores Inc.



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Special thanks to Edu Mendes for the Brazil's cover image.

China



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

Capital²: Beijing
(Number of inhabitants: 14.9 million)

Population (million): 1,307
(US 296 – EU25 459 – World 6,000)

Median age³: 33 years

Nominal GDP (USD billion)³: 2,224.9
(US 12,487 – EU25 13,447 – World 44,183)

Nominal GDP (USD billion at PPP): 8,227
(US 12,487 – EU25 12,657 – World 59,763)

GDP per head (USD at PPP): 6,292.4
(US 42,129 – EU25 27,538 – World 9,962)

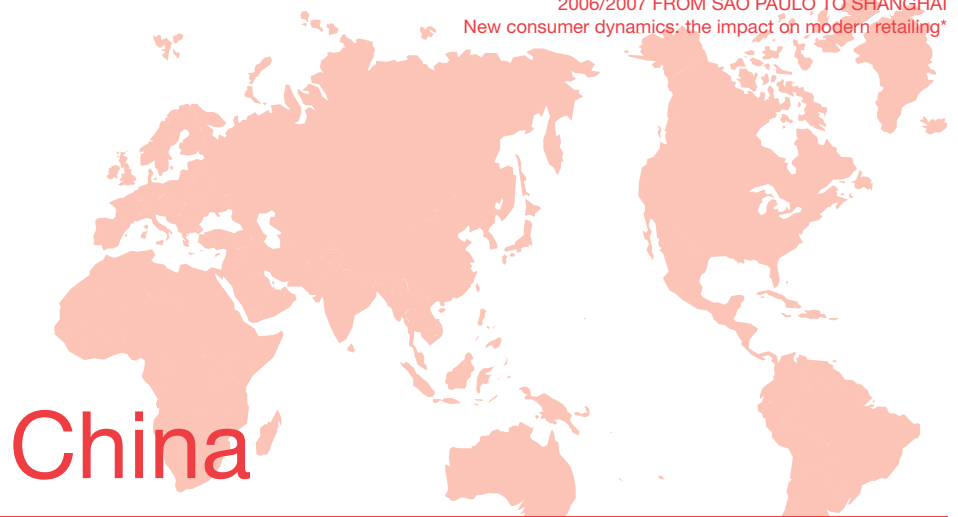
Currency³: Chinese Yuan Renminbi (RMB)
(USD1 = RMB8.2)

Languages³: Standard Chinese or Mandarin, Yue (Cantonese), Wu (Shanghaiese), Minbei (Fuzhou), Minnan (Hokkien-Taiwanese), Xiang, Gan, Hakka dialects, minority languages

Main religions³: Taoist, Buddhist

Government type³: Communist state

Sources: () Economic Intelligence Unit 2006 data,
(¹) World Bank 2005, (²) National Bureau of Statistics,
(³) CIA Fact book



GDP AND CPI

Strong economic development fuelled by rapid growth

ECONOMIC OVERVIEW

Accession to the 4th economic rank in the world

China's ongoing economic reforms in the last two decades have opened the economy to international trade and investment. The economy continues its robust surge upward, growing by a strong 9.9% in 2005, with a gross domestic product (GDP) of USD2,224 billion. The figures are more staggering in purchasing power disparity, estimated to be at USD8,227 billion or USD6,292 per capita.

China's economic development has been fuelled by the rapid growth of fixed asset investment, backed by a high domestic saving rate, huge inflows of foreign direct investment (FDI) and major efforts in infrastructure. Services and industry accounted for 39.8% and 53.1% respectively of the GDP in 2005.

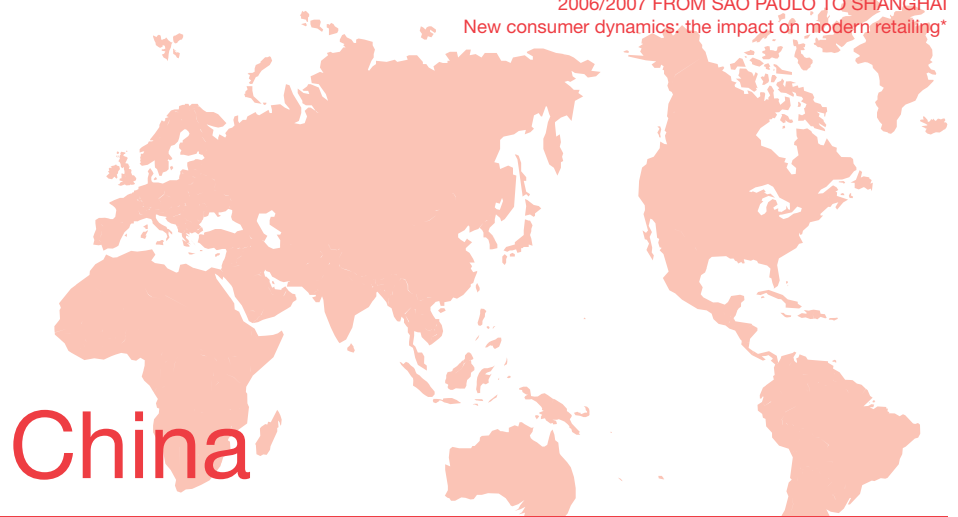
China's implementation of the World Trade Organization (WTO) requirements is giving further impetus to investor interest, as is the continued liberalisation and deregulation in banking and finance, insurance, telecommunications, and wholesale and retail sectors. China is now the fourth largest economy in GDP terms, behind the US, Japan and Germany. The country is also the world's third largest trader, exporting USD752.2 billion worth of goods in 2005, while importing USD631.8 billion.

China's consumer price index (CPI) posted a moderate growth of 1.8% in 2005, 2.1 percentage point lower than that of the previous year.

GDP and CPI

	2002	2003	2004	2005
GDP growth (%)	9.1	10.0	10.1	9.9
CPI (%)	-0.7	1.2	3.9	1.8

Source: EIU, July 2006



ECONOMIC FORECAST

Maintaining steady economic development

Despite the government's effort to slow down investment and prevent the economy from overheating, China's economy continued to surge forward with GDP growth estimated to be 9.6% for the whole year. Factors such as political and social stability, improvements in labour productivity due to increased opening and reform and technological advances are expected to sustain an economic growth rate of 8% to 9% annually over the next five to ten years.

Inflows of FDI are expected to stay steady in the next few years as China continues to implement WTO requirements. Government officials forecast that actual FDI will remain at USD100 billion annually throughout the 11th Five-Year Plan (2006 to 2010), the country's blueprint for economic policy.

The CPI for the first six months of 2006 is estimated to be 1.3% and is expected to remain at around 1.2% for the whole year. Rising prices for oil and raw materials may lead to consumer prices increase and stoke inflation fears. But experts find no evidence that China is facing inflation as supply of most products surpasses demand and there is little room for the CPI to pick up.

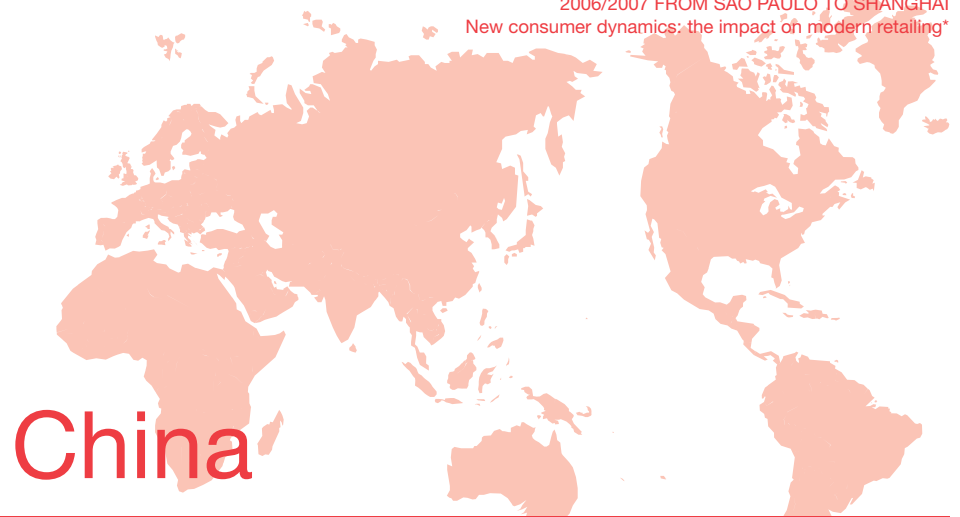
In a bid to continue maintaining a steady development of the economy, the Chinese central government aims to spur domestic consumption by increasing consumer purchasing power. Increasing residents' income, raising the personal income tax threshold, hiking the pension payment of the retired, abolishing all agricultural taxes and enhancing subsidies to farmers are among the measures the government has taken to boost disposal income. The central government has allocated more public funds for healthcare and education to ease the household burden. Fostering domestic demand has taken centre stage in the 11th Five-Year Plan.

Besides public policy to stimulate consumption, the change in population demographics is another strong driver for consumer spending in China. The generation of free-spending young Chinese would prop up the economy unlike their parents who are more prone to save.

GDP and CPI forecast

	2006	2007	2008
GDP growth (%)	9.6	8.3	8.1
CPI (%)	1.2	2.1	2.5

Source: EIU, July 2006



CURRENCY REFORM

In July 2005, China changed its currency regime to a currency-basket model. The Renminbi was re-valued by 2.1% against the US dollar. The Renminbi has appreciated by a further 1.1% since then. This move, though modest, may signal the start of a shift towards a more flexible exchange rate regime, which will be essential if China were to move towards a market-oriented financial system.

UNEMPLOYMENT

Challenging unemployment

Despite strong economic growth, continued structural reform is creating challenges for China in terms of employment. The official unemployment rate for 2005 was 4.2% (9.4 million). However, EIU estimate puts urban unemployment, including workers laid off from state-owned enterprises, to be 9%.

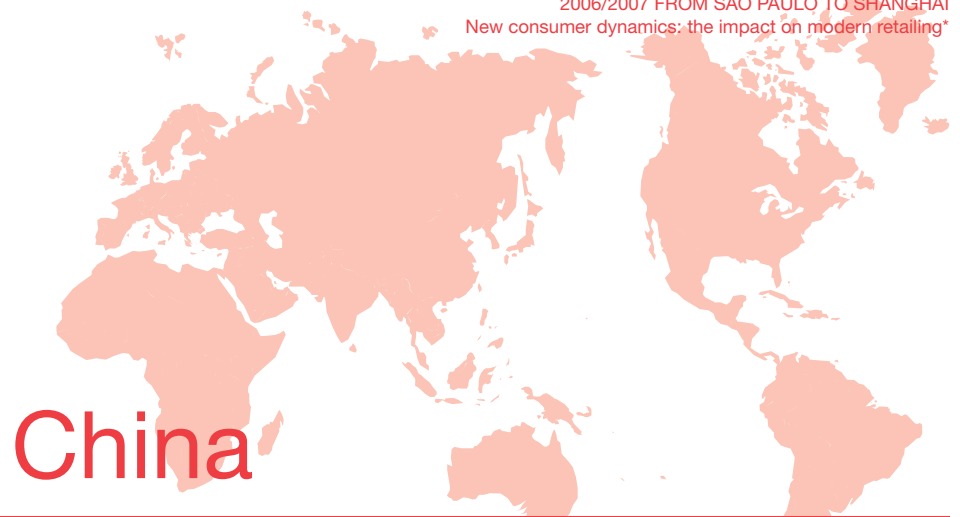
Unemployment rate and forecast

	2002	2003	2004	2005	2006	2007	2008
%	9.7	10.3	9.9	9.0	9.3	9.2	9.1

Source: EIU, July 2006

China created some 9.7 million jobs in 2005 and is adopting measures, including offering technical training and providing small-scaled loans in 100 pioneer cities, to help people find work.

According to estimates by the country's National Development and Reform Commission, the average number of jobless will reach 12.3 million during the period between 2006 and 2010.



FOREIGN DIRECT INVESTMENT

A leading destination for FDI

REGULATORY ENVIRONMENT

A challenging regulatory environment

FDI in China occurs most commonly through foreign-invested enterprises (FIEs), which can be established wholly or partly within China, and the foreign investor must hold at least 25% ownership. FIEs are mainly in the form of:

- Equity joint ventures – limited liability companies with joint Chinese and foreign ownership set up for a specific purpose. The share of the results is determined by the equity contributions to the joint venture by the two parties.
- Cooperative joint ventures – similar to equity joint ventures but the obligations of the two parties are specified in a contract, in which the share of results is also stated.
- Wholly foreign-owned enterprises (WFOEs) – legal entities wholly owned by one or more foreign investors. Industries in which WFOEs are not allowed are set out in the government's Catalogue Guiding Foreign Investments, published in 1995 and amended in 2002 and 2004.

FDI

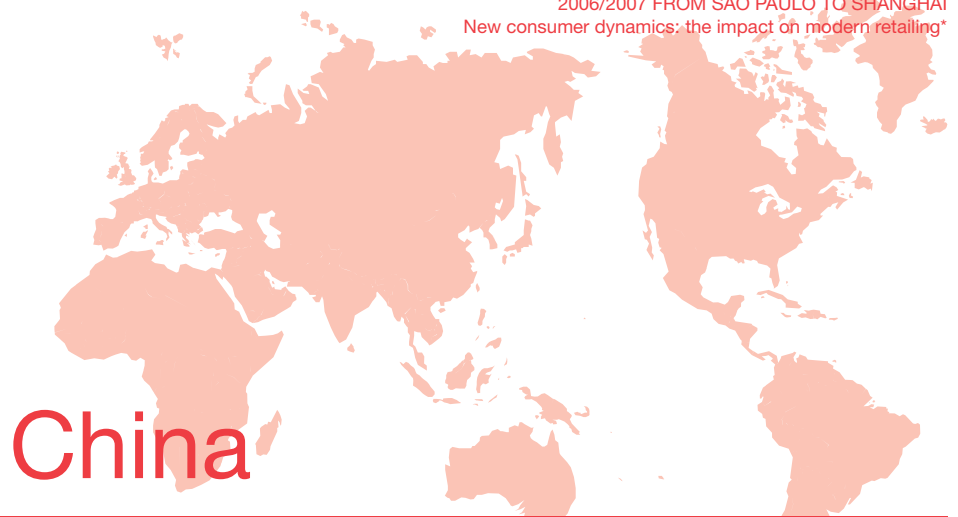
	2002	2003	2004	2005
FDI (RMB bn)	408.1	389.7	454.7	648.4
FDI (USD bn)	49.3	47.1	54.9	79.1

Source: EIU, July 2006

RETAIL REGULATIONS

A broad range of legislation

In fulfilment of its WTO commitments, China has gradually opened many sectors in which foreign investment had previously been restricted, among which is the distribution sector. The key regulations implementing this revised policy are the Measures for the Administration of Foreign Investment in the Commercial Sector (Commercial Measures), effective from 1 June 2004, and the Circular on Issues Regarding the Delegation of Approval Authority for Foreign-invested Commercial Enterprises to the Local Authorities (Circular 94) of the Ministry of Commerce (MOFCOM), effective from 1 March 2006. These developments, together with other policy changes, have given foreign investors greater access to the country's distribution sector.



Foreign invested commercial enterprises

A special legal entity for investors

Under the Commercial Measures, foreign investors are allowed to engage in four forms of distribution activities, namely retailing, wholesaling, franchising and commission agents' services. A foreign investor must set up a foreign-invested commercial enterprise (FICE) in order to engage in these distribution activities. FICEs are also permitted to import and export products regardless of their origin. FICEs can engage in other relevant ancillary business activities such as warehousing, inventory management and delivery.

An FICE may be a Sino-foreign joint venture or a wholly foreign-owned enterprise. Under the Commercial Measures, market entry threshold on capital requirements are substantially reduced and geographical restrictions were abolished. An FICE may engage simultaneously in one or more of the business activities mentioned above and may authorise third parties to open franchises shops.

Under Circular 94, the approval of FICEs in general is delegated to MOFCOM at local provincial level and the Administration Committee of the Economic and Technological Zones (ETDZs) for FICEs to be set up in state-approved ETDZs. MOFCOM, however, remains the approval authority if the proposed FICE is involved in sales through television, telephone, mail order, internet, etc., or in the distribution of strategic raw materials.

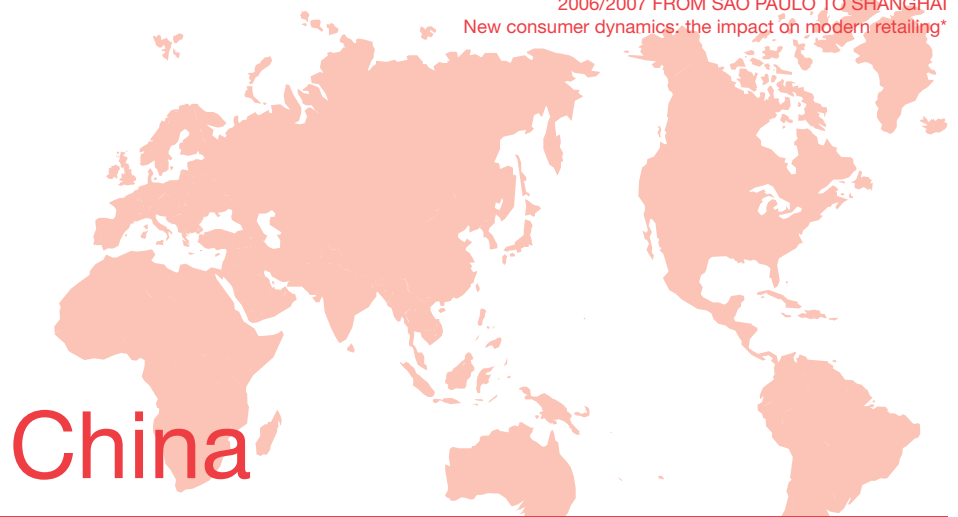
New store openings

Local authorities approve in most cases

The objective of Circular 94 is to simplify the approval procedures and improve efficiency in face of the growing number of FICE applications. Local MOFCOM authorities are authorised to approve new outlets if:

- The area of a single store does not exceed 5,000 square metres, the number of stores does not exceed three, and the total number of similar stores opened by the foreign investor in China via FICE does not exceed 30; or
- The area of a single store does not exceed 3,000 square metres, the number of stores does not exceed five, and the total number of similar stores opened by the foreign investor in China via FICE does not exceed 50; or
- The area of a single store does not exceed 300 square metres.

In the case where an FICE is to be established by means of merger and acquisition by a foreign enterprise, and the foreign enterprise and target domestic enterprise are under the control of the same management or individual, approval from MOFCOM is still required.



CLOSER ECONOMIC PARTNERSHIP ARRANGEMENT

*Fluid relations with Hong
Kong based companies*

On 29 June 2006, further trade liberalisation measures were announced under the fourth round of the Closer Economic Partnership Arrangement (CEPA), a WTO-compliant, free trade agreement which was first signed by the central government of China and the Hong Kong government and came into full effect from 1 January 2004. CEPA provides preferential access to the mainland market and reduces tariffs for the export of certain finished goods and services by qualified Hong Kong-based companies, whether locally or foreign owned.

The latest round of the CEPA benefits covers two broad areas:

- With effect from 1 January 2007, market access to 10 areas in the mainland already included in the CEPA will be relaxed further. The areas involved are: legal, construction, information technology, conventions and exhibitions, audiovisual, distribution, tourism, air transport, road transport and individually owned stores.
- Trade and investment facilitation measures will be extended to include the protection of intellectual property with immediate effect. One of the key means of improving cooperation in intellectual property protection will be the establishment of an Intellectual Property Protection Coordination Centre in Hong Kong. The Centre will facilitate the exchange of information relating to the formulation and implementation of intellectual property laws and regulations, and more.

Under the new measures, the maximum shareholding of qualified Hong Kong-based companies in retail businesses with over 30 stores in China will be raised – from currently not exceeding 51% to 65% from January 2007.

CEPA continues to have a positive impact on attracting investors to Hong Kong. About 23% of foreign companies establishing in Hong Kong in the first half of 2006 indicated that CEPA played an important role in their decision to invest in Hong Kong. Strategically CEPA opens a new chapter in cross-border trade and investment between Hong Kong and mainland China and reinforces Hong Kong's position as an ideal location to do business with China.

DIRECT SELLING

*Permitted under WTO
requirements*

Direct selling had been banned in China since 1998 after the sector was fraught with scandals and frauds. The Chinese government permitted only 10 foreign-invested direct selling companies to operate in China through retail outlets with employed sales representatives. As part of China's WTO commitments, market access for "wholesale or retail trade services away from a fixed location" has to be granted. On 2 September 2005, China issued



China

two long-awaited new regulations governing the direct selling sector, namely Measures for the Administration of Direct Selling (Direct Selling Measures) by MOFCOM and the Anti Pyramid Promotional Scheme Regulations (Anti Pyramid Regulations) by the State Administration for Industry and Commerce.

Under the Direct Selling Measures, effective from 1 December 2005, companies applying to engage in direct selling must meet the following four requirements:

- They must have goodwill and have no record of serious irregularities in business practice in the preceding five years, and foreign investors must have at least three years of experience in direct selling in China;
- They must have a minimum paid-up registered capital of RMB80 million (USD10 million);
- They must pay a bond deposit of RMB20 to 100 million (USD2.5 to 12.5 million) to a designated bank; and
- They must establish an information reporting and disclosure system.

The Direct Selling Measures also impose various other requirements, including rules on operation mode, rate of commission, and recruitment and training of sales persons.

The Anti Pyramid Regulations, effective from 1 November 2005, aim at eliminating illegal pyramid schemes. Penalties for violating the Anti Pyramid Regulations are fines up to RMB2 million (USD0.25 million) per occurrence or criminal charges, depending on the seriousness of the violation.

FRANCHISING

Unrestricted market access

The Measures for the Administration of Commercial Franchise Operations, effective from 1 February 2005, removed restrictions on market access and apply to all enterprises engaged in commercial franchise in China. A franchiser must have at least two directly owned outlets in China for at least one year before it may lawfully grant franchises. FIEs wishing to engage in commercial franchising must register and obtain approval of the relevant government authorities. They are also subject to a number of pre-sale and ongoing disclosure obligations.

INTELLECTUAL PROPERTY RIGHTS

Legislation is under active development

In a bid to enhance protection of intellectual property, China has formulated an Action Plan on Intellectual Property Rights (IPR) Protection 2006. The action plan covers trademark, copyright, patent and import-export, and



China

encompasses nine areas of protection, namely legislation, law enforcement, mechanism building, publicity, training and education, international exchange and cooperation, promotion of business self-discipline, provision of services to rights holders, and topical research.

Under the 2006 Action Plan, existing laws and regulations on trademark, copyright and patent will be revised while new administration measures and rules will be drafted to offer greater IPR protection. Enforcement actions will be stepped up in investigation, crackdown and supervision in the various areas of IPR protection.

In tandem with legislative and enforcement actions, China has also concentrated efforts on raising public awareness on the importance of respecting IPR. Various campaigns are launched across the country; for example, an IPR protection website, www.ipr.gov.cn, was launched in April 2006 to introduce to domestic and overseas readers China's laws, rules, policies and measures concerning IPR protection.

The State Intellectual Property Office will join the National People's Congress Standing Committee in monitoring the enforcement of the Patent Law. Report centres will be established to handle IPR violation complaints as a means for building a mechanism with long-term effectiveness.

In terms of international exchange and cooperation, efforts will focus on legislation, copyright, patent and customs protection, with 19 projects being planned. Among these, seven are joint campaigns between China and the US.

China is making earnest efforts to address the issue of IPR protection, but as in all other countries, this issue will remain a constant major challenge for some time to come.

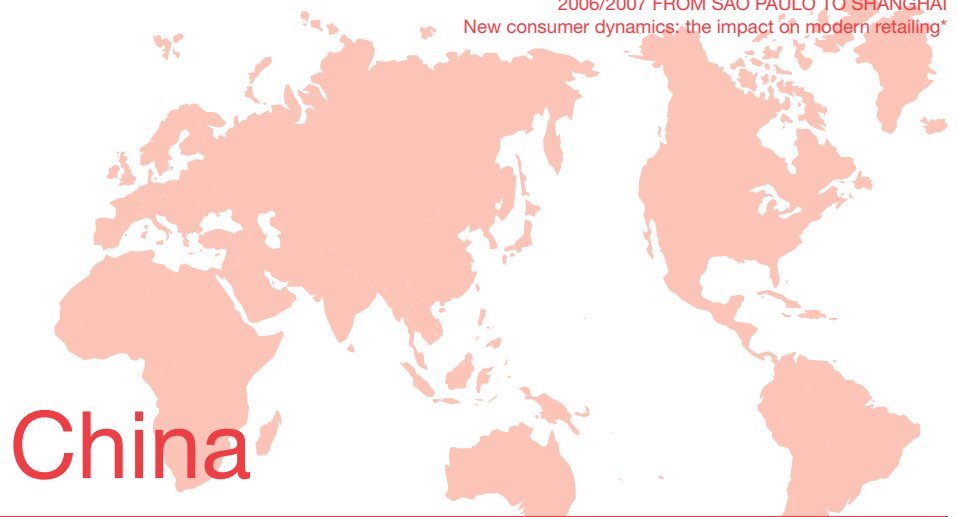
PROPERTY/REAL ESTATE SECTOR

Restrictions on foreign ownership

According to China's National Development and Reform Commission, the number of newly established foreign-invested real estate enterprises increased by 25.4% year-on-year in the first half of 2006. The amount of foreign capital actually utilised was up 27.9%, reaching RMB389.2 billion (USD48.8 billion).

In a bid to curb foreign capital from over-investing in the real estate sector and to control property speculation, the State Council approved on 11 July 2006 a guideline entitled Opinions on Regulating the Administration and Entry of Foreign Investment to the Real Estate Sector (Circular 171).

Under Circular 171, jointly drafted by six government authorities including the Ministry of Construction and the People's Bank of China, foreigners need to be resident in China for at least a year and foreign enterprises must have



CONSUMPTION TAX

Levied on “luxury” goods

branches or representative offices in China before they can buy residential properties or office premises for their own use. If foreign institutions and individuals invest in domestic property not for their own use, they must apply to set up an FIE to engage in real estate investment, operations, and/or development. The ratio of registered capital should be no lower than 50% of any project with total investments of more than USD10 million.

Other rules and regulations have also been implemented to control property transactions among domestic residents, including the imposition of tax on sellers. The objective is to cool down the heated property sector and rein in rampant speculation.

Consumption tax was first introduced in China in January 1994 when the indirect tax system was reformed and also for the purpose of controlling excessive production and consumption of luxury products. Consumption tax affects mainly the producers and end-users of selected consumer goods such as cigarettes, beer, skin and hair-care products and gasoline. Different tax rates apply to different items.

New changes were introduced in 2006 and some of these changes affect consumer goods. Effective from 1 April 2006, consumption tax on skin care (except high-end products) and hair care products was eliminated, as these products are no longer regarded as luxuries but daily-use products. High-end skin products, however, are now taxed at the same rate as cosmetics at 30%. The new rates and definition of high-end skin care products are yet to be announced, but some high-end product players have already adjusted their price in stages to cushion the shock so as to retain their customers.

The category “motor cars” is reclassified into “passenger cars” and “commercial vehicles”. For passenger cars, the former three levels of tax rates – 3%, 5% and 8% – have been replaced by six levels of tax rates, from 3% to 20%. Commercial vehicles are subject to a single rate of 5%. For motorcycles, the tax rate is reduced from 10% to 3% for motorcycles with cylinder capacity of 250ml or less and 10% for all others.

Consumption Tax, which ranges from 8% to 20% is also payable on certain imported consumer products.

FOREIGN ENTERPRISE INCOME TAX

*Levied on all foreign-invested
retail and wholesale activities*

The Foreign Enterprise Income Tax Law provides for a standard FEIT rate of 33%, consisting of a 30% state income tax and a 3% local tax. Currently, there is no specific tax incentive that is granted to foreign-invested retail and



China

VALUE-ADDED TAX

Basic rate of 17%

wholesale companies. However, if these companies are registered and operate in those state-approved special investment zones, such as Shanghai Pudong New Area, a reduced FEIT rate (e.g. 15%) would apply. Nevertheless, reform of the China income tax system has been under discussion for some time. A new unified corporate income tax law may be promulgated soon as it is reported that the draft law will be laid before the State Council for review in October 2006. The FEIT rate as well as any preferential tax treatments currently available to foreign-invested enterprises will likely be changed.

In addition to FEIT, the importation and sale of tangible goods will be subject to VAT in general. The standard VAT rate is 17% while certain goods are taxed at the lower rate of 13% or are exempt from VAT. Exports are zero-rated and related input VAT, after absorbing certain non-creditable portion (depending on categories of goods) as cost, could be fully or partially refunded. VAT is levied on the basis of the value added to the taxable goods at each stage of a supply chain.

Import VAT, which is normally assessed at the rate of 17%, is also payable.

CUSTOMS

*Many duty reductions
following WTO membership*

Customs or import duties are levied by the customs authority on goods imported into China based on predefined and published nomenclature, per the Harmonised System. Customs duty is levied based on the Cost, Insurance and Freight (CIF) Transaction Price of the imported goods at the rate of duty specified in the PRC Customs Tariff.

China has progressively reduced import duties in accordance with its WTO commitments. The average import duty rate is now 9.9% and this will be reduced marginally to approximately 9% in 2006. Import licensing, tariff quota and similar non-tariff barriers have also been substantially eliminated for most consumer products in recent years. Other non-tariff barriers, such as the Compulsory Certification Catalogue (CCC), may apply to certain consumer products.

Since China's WTO accession, foreign-invested companies may now acquire import/export rights direct without having to trade through a third party Import/Export Company, which was historically the normal practice. This should reduce the landed cost of imported goods and also simplify the import/export procedures and processes. China is also entering into preferential trading arrangements with other countries. Most notable is the ASEAN grouping that comprises key countries such as Thailand, Malaysia and Singapore. Under the ASEAN China FTA, trade between these countries can take place with lower (preferential) customs duties imposed. Free trade areas such as these can enable improved market access into China.



China

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

Increasing urban and rural incomes help to fuel a dynamic consumption but companies must remain wary of diverse cultures and spending habits in this vast and complex market

**POPULATION
EVOLUTION**
Slowing population growth

China's population in 2005 is estimated to be slightly over 1.3 billion. Annual population growth rate has been relatively low, about 0.73% between 2000 and 2005. Over the next decade, the population is expected to increase at around 1% annually, reaching 1.4 billion by 2015.

In 2005, 934 million people were of working age (15 – 64 years). The United Nations estimate that by 2015, the economically active population in China will stand at 1005 million.

Population

	2002	2003	2004	2005
Population (m)	1,284.5	1,292.3	1,299.9	1,307.4

Source: EIU, July 2006

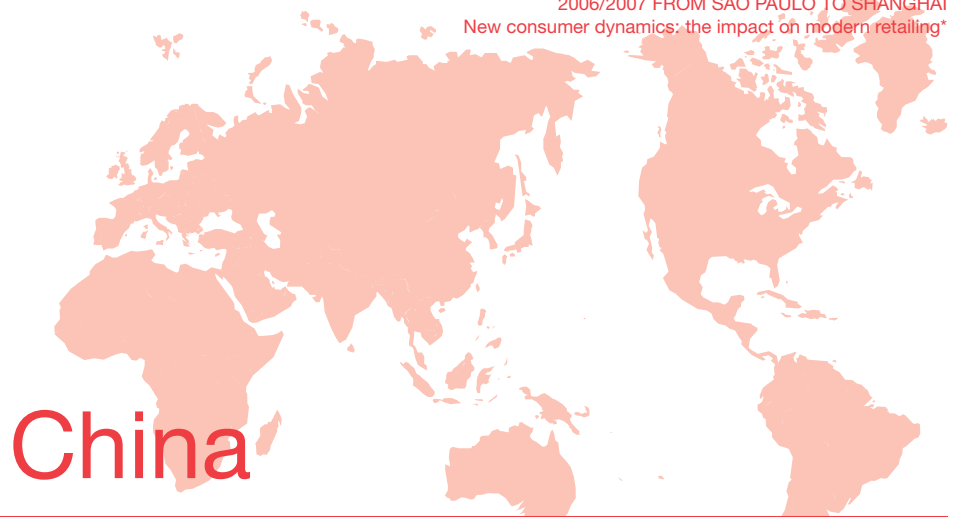
**POPULATION BY
AGE GROUP**
*Steadily ageing
demographic pattern*

More significant than the size increase is the change in age composition of the population. Between 2000 and 2005, the under-20 population declined by almost 27 million and is expected to drop by a further 72 million over the next decade by 2015. The main reasons for this decrease are delayed marriage and childbirth. The number of young adults (20 to 34 years) will increase by 77 million between 2005 and 2015. At the same time, by 2015, the number of older working population (50 to 64 years) will have increased steadily to almost 266 million, and so will the number of the over 65, reaching 105 million.

Age profile

% of total population	1999	2004	2009 (f)	Trend
0-14 years	25.9	22.3	19.8	↓
15-64 years	67.4	70.3	72.1	↑
Over 65 years	6.7	7.5	8.1	↑

Source: EIU, July 2006



URBANISATION OF THE POPULATION

*Government efforts to bridge
rural/urban income gaps*

The shift in age distribution of the population will directly impact on the consumer market in China. The drop in the number of children will mean less spending on child-related products such as toys, games and children clothing. At the same time, households with no children will have more money to spend on items such as home improvements, consumer electronics, travel and entertainment.

On the other hand, the increase in the ageing population implies that more demand will be generated on services and products in healthcare, pharmaceuticals, insurance and the like.

Official residence registrations show that China's rural population stands at 940 million or some 60% of the total population in 2005. The government, however, points out that the total of actual rural dwellers is about 750 million people as about 200 million people have migrated to work in cities and towns.

Urban/Rural split

% of total population	1999	2004	2009 (f)
Urban	34.9	39.5	44.1
Rural	65.1	60.5	55.9

Source: EIU, July 2006

The urbanisation rate currently stands at 1.4%, which means that about 20 million rural dwellers become urban residents each year. Official statistics indicate that nearly 40% of rural dwellers' annual per capita income, about USD395, was earned in cities.

As part of the continuing effort to reduce income disparity and rural poverty, and to sustain urbanisation of the population, the Chinese central government announced in March 2006 a series of measures to build a "new socialist countryside" over the next five years. The aim of the new measures is to improve living standards and productivity levels in rural areas. Included among the measures are increasing rural infrastructure spending, removing agricultural taxes, increasing rural education expenditure and upgrading healthcare systems in rural areas.



China

INCOME/BUYING POWER

*Unequal regional distribution
of growing prosperity*

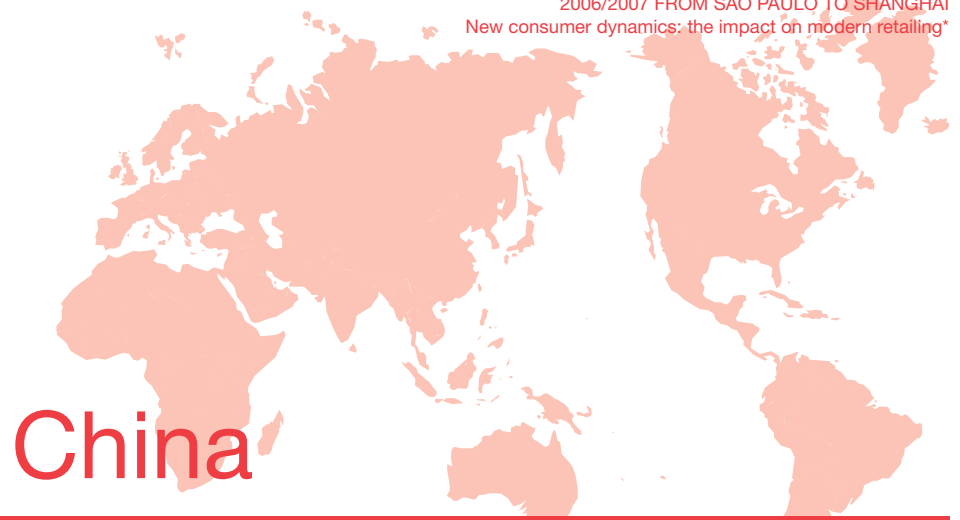
Both urban and rural incomes have witnessed impressive growth since the introduction of structural and economic reforms in China. The annual per capita disposal income of urban households was RMB10,493 (USD1,280) in 2005, a real increase of 8.8% year-on-year. The annual per capita net income of rural households was RMB3,255 (USD397), a real increase of 6.2% year-on-year after deducting price factors.

Major coastal cities such as Shanghai, Beijing, Guangzhou and Shenzhen are more affluent than the other parts of China since these cities were the first to open their economy some two decades ago. Per capita household disposal incomes in these cities are in general higher than the national average. Sustained economic growth and the rapid expansion of modern retail format in recent years spread China's new-found wealth to other cities as well, in particular those in the Pearl River Delta and the Yangtze River Delta.

Rural dwellers also benefit from this boom in the economy, though to a far lesser extent. Migrant workers who work in the cities are sending back home their earned savings, which reached the substantial amount of RMB370 billion (USD44.7 billion) in 2003. Such income transfers are growing and are expected to boost the buying power of rural households. Indeed rural dwellers are changing their concept on consumption with this enhanced financial position.

Economic indicators of the 10 most prosperous provinces/municipalities, 2004

Province/Municipality	Major cities	Population (Million)	GDP per capita (RMB'000)	Household consumption (RMB'000)	
				Urban	Rural
Shanghai	N/A	17.4	46.3	20.9	9.1
Beijing	N/A	14.9	41.1	15.0	5.5
Tianjin	N/A	10.2	30.6	11.4	4.7
Zhejiang	Hangzhou, Ningbo	47.2	24.4	12.8	4.7
Guangdong	Guangzhou	83.0	20.9	11.4	3.4
Jiangsu	Nanjing	74.3	20.2	9.1	3.5



Shandong	Qingdao, Jinan	91.8	20.0	8.5	3.3
Fujian	Fuzhou, Xiamen	35.1	16.5	9.7	4.8
Liaoning	Dalian, Shenyang	42.2	15.8	7.7	2.8
Inner Mongolia	Baotou	23.8	12.8	7.5	2.1

Source: National Bureau of Statistics

AVERAGE HOUSEHOLD SPENDING PATTERN

*Expenditure on non-basic goods
is on a steady upswing*

Increase in per capita income, improvement in living standard and the rapid spread of modern retail format have led to a change in the household consumption pattern. Urban residents are now spending more on discretionary items such as computers, mobile phones, consumer electronic products and healthcare services and products, as well as big-ticket items such as house purchase, cars and overseas travel.

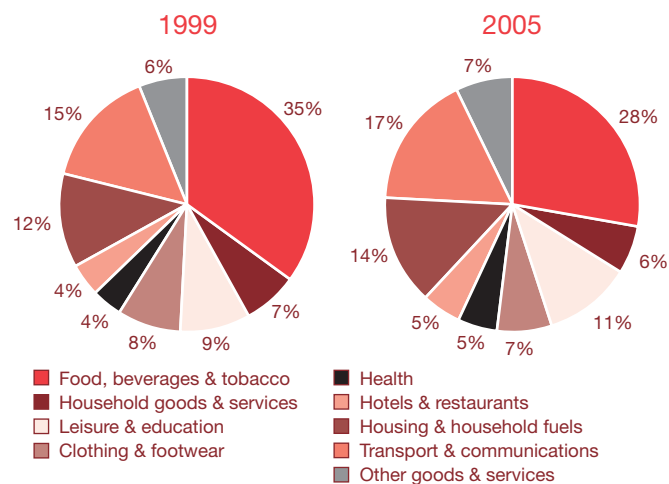
Rural consumers are also changing their concepts of consumption. Remittances sent home by migrant workers has enabled many rural dwellers to spend on items beyond the basics. Ownership of durable goods is on the rise and home improvements are more prevalent in certain parts of the rural regions now.

A word of caution is necessary however. China is a vast, complex market where huge regional differences exist. Such differences are not just about income or spending. The diversity in lifestyle, food preferences, custom and tradition, and business styles are just some of the points that foreign companies investing in China must take into account, not only in their choice of product and service mixes, but also in dealing with and managing their local enterprises.



China

Composition of average household expenditure: 1999 vs 2005



Source: EIU, July 2006

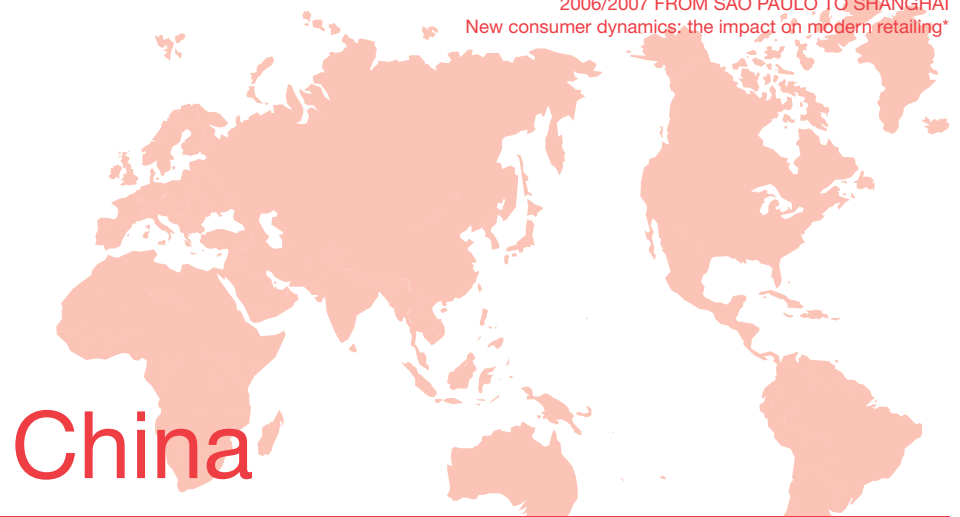
LIFESTYLE/ SHOPPING HABITS

A middle-class lifestyle is strongly affirming itself

According to the National Bureau of Statistics (NBS) of China, middle class household is defined as those with annual household income of RMB60,000 (USD7,322) to RMB500,000 (USD61,016). Currently, 5% of total households fall within this definition, but according to NBS forecast, by 2020 this percentage will increase to 45% of total households.

Indeed, the rising middle class is already a force that retail and consumer companies must reckon with. These middle class residents are avid consumers of a wide variety of durable goods such as high-end electrical and electronic appliances, upmarket fashion and upgraded home goods. They are also spending more on services such as entertainment and recreation, healthcare and fitness and financial and insurances. The growth in size, income and wealth accumulation as well as the changing consumption pattern of the middle class will play a major role in shaping the consumer market of China in future.

China's young population, those between 13 and 24 years old, is the first generation of the one-child policy to have a wide range of lifestyle choices. Like their counterparts in the West, friends and advertisements in magazines, televisions and the Internet about new trends and styles have the most influence on them.



BRAND/PRICE SENSITIVITY

*A complex attitude to
brand value*

The attitudes towards brands among Chinese consumers seem to be ambivalent. For luxury goods, whether be it fashion or home goods, brands certainly matter as famous brand names and the fact that one can afford them are regarded as status symbol. However, when it comes to other products such as packaged goods or daily-use products for the home, consumers are less concerned about brands but more on price and product quality.

Though foreign brands are still regarded as more superior and speak louder as status symbols among the urban affluent consumers, the rapid emergence of domestic brands, particularly in consumer-packaged goods, is posing serious competition to foreign ones. However, the success of foreign consumer companies like Nestlé, Danone and Procter & Gamble in penetrating the Chinese market proves that it is product quality, localisation and offering that ultimately determines popularity among Chinese consumers.

Consumers' favour in brands varies from product to product. Where health and safety are issues of concern such as cosmetics and toiletries, foreign brands such as Unilever, Procter & Gamble, L'Oréal and Shiseido feature strongly. For daily-use products such as detergents and household care products, consumers make no distinction between foreign or domestic brands and tend to favour local brands, which are lower in price.



China

RETAIL AND CONSUMER SECTOR PERFORMANCE

While growth is strong overall, segment performance is uneven due to regional and social differences in consumer demands as well as the varying quality of infrastructure across the market.

MAJOR CONSUMER GOODS PLAYERS

Increasing competition for consumer loyalty

Urban demand for convenience retail and ready-to-eat products

Opportunities for developing the rural market

Over the past decade, China's fast moving consumer goods (FMCG) market has witnessed enormous growth, but at varying rates for different sectors because of consumer characteristics, product supply and distribution.

Well-off urban consumers in higher-tier cities are in general more receptive to and able to afford most FMCG products. The emergence of foreign FMCG products and their subsequent success in changing consumer habits has, however, resulted in widespread imitation from domestic companies. Consumers have many choices available and building brand loyalty is a challenge.

At present, imported packaged foods' market penetration is relatively low. They are popular among urban consumers in higher-tier cities as imported packaged foods are perceived to be of higher quality, safer and more stylish. More frequent travel overseas has also whet the appetite of many Chinese consumers for ethnic food and foreign cuisine.

Traditionally, fresh foods have been the staple of Chinese diet. However, urban consumers are changing their eating habits and shopping pattern in their quest for speed and convenience. The busy urban workers, in particular working women, find relief from cooking burden in packaged and convenience foods. The spread of supermarkets makes it easier to buy packaged and convenience foods. Total sales of packaged foods in 2004 reached almost RMB43 billion (USD5.2 billion), an increase of some 9%.

Rural residents, on the other hand, are much less receptive to packaged foods. Major reasons for this attitude include tradition, lower income level and low household penetration of refrigerators and microwave ovens. The underdeveloped retail network and distribution infrastructure results in higher retail price of packaged food and makes it less affordable among rural consumers.



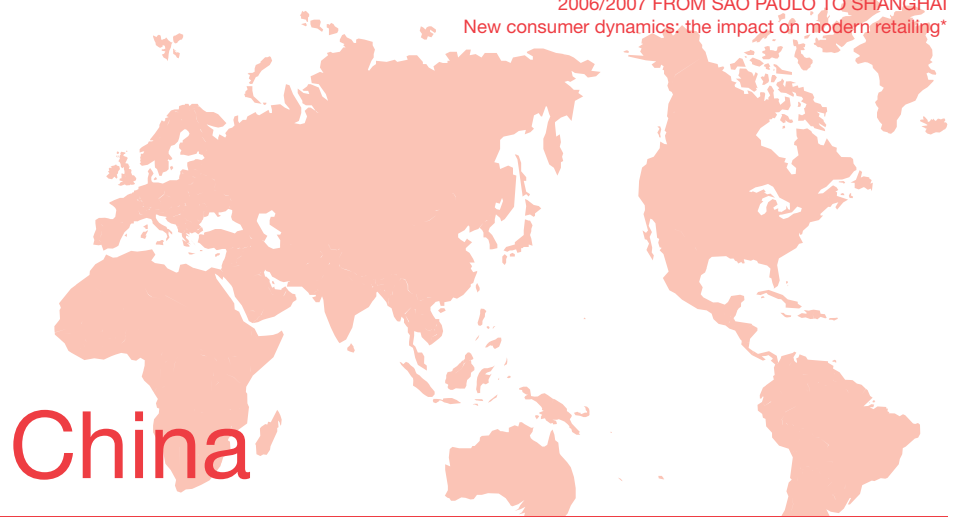
China

However, with the central government's initiative in building a national retail market in the rural regions, the development of the rural retail market will be accelerated and enhanced. Rural consumers will have easier access to wider product offerings at lower prices.

Major consumer goods players in selected sectors

Sector	Brand (Global Brand Owner)	Company (National Brand Owner)	Market share %	
			2003	2004
Cosmetics and toiletries	Amway (Alricor Inc)	Amway (China) Co. Ltd	4.7	5.5
	Olay (Procter & Gamble)	P&G (Guangzhou) Ltd.	4.3	5.2
	Avon (Avon Products Inc)	Avon (China)	2.8	3.3
Household care products	Diao	Zhejiang Nice Daily Use Chemical Co. Ltd.	14.8	14.1
	Keon	Shanxi Nafine Chemicals Group Ltd.	7.1	7.1
	Liby	Guangzhou Liby Co. Ltd.	6.3	6.6
Packaged foods	Mr. Kon	Ting Hsin International Group	3.2	3.3
	Yili	Inner Mongolia Yili Industrial Group	2.3	2.9
	Mengniu	Inner Mongolia Mengniu Group	1.3	2.1

Source: Consumer China 2006, Euromonitor



MAJOR RETAIL PLAYERS

Government initiatives

Increasing regulation to homogenise development

The breakneck pace of development of the retail sector has engendered market irregularities such as food safety problems, substandard products, unscrupulous business practices and bogus advertising. To better protect consumers and market players, and to ensure the healthier and more orderly development of the retail sector, the Chinese government has launched a series of regulations and policies in 2005. The following is a snapshot of the new rules:

- Measures for the Administration of Retailers' Sales Promotion – to regulate the sales promotion activities launched by retailers to protect the interest of consumers;
- Measures for the Administration of Transactions between Retailers and Suppliers – to regulate purchasing transactions between retailers and suppliers, with detailed provisions on the content of purchase contract, payment method, monitoring by local commercial authorities, establishing a risk warning mechanism;
- Measures for the Administration of Food Hygiene Licensing – to tighten the issue of licences and to promote good practices among food producers in order to regulate the food market and ensure food safety; and
- Anti Pyramid Regulations – to step up inspection to enforce the government's ban on pyramid schemes, particularly with the coming into effect of regulations on direct selling.

Retail sales

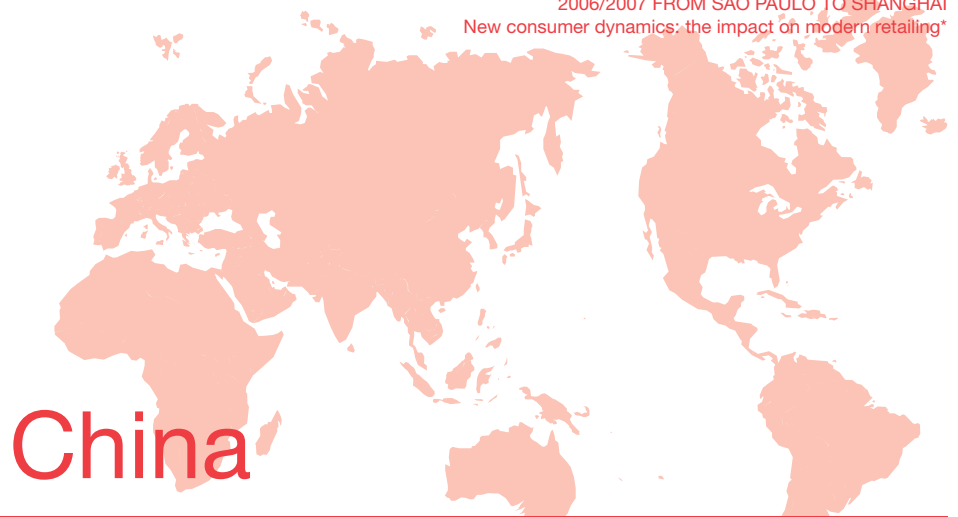
Continuing growth

China's total retail sales reached USD797.4 billion in 2005, a growth of 13.7% over 2004. The combined sales of the China's top 100 chain enterprises amounted to RMB707.6 billion (USD86.3 billion), an increase of 42% year-on-year. The number of stores operated by the top 100 chain enterprises was 38,260, up 26% from the previous year.

Retail sales

	2003	2004	2005
Retail sales (USD m)	573,232	681,777	797,361
Retail sales growth (% p.a. in RMB)	11.2	14.5	13.7

Source: EIU, July 2006



Food retail channels

Supermarkets *Dominated by domestic players*

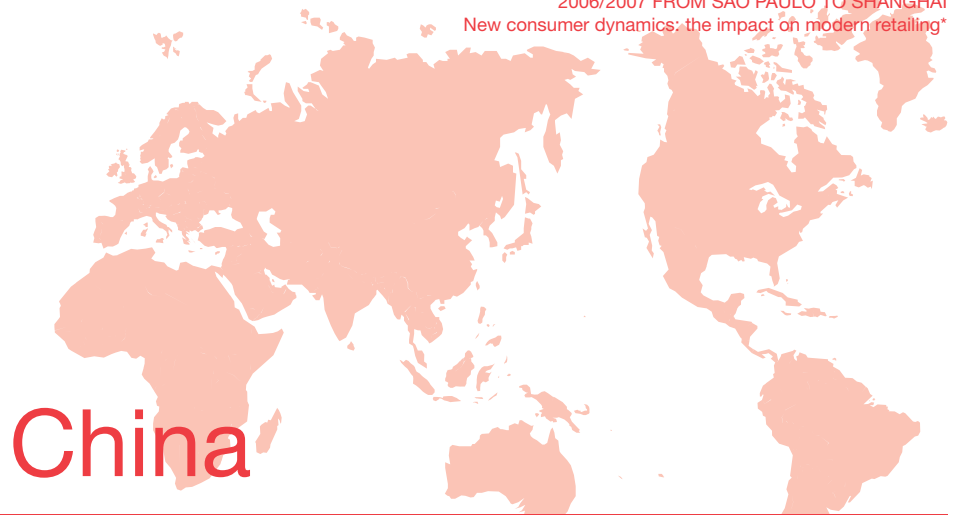
Between 11 December 2004 (when China fully opened its distribution sector) and the end of 2005, 1,027 foreign-invested retail enterprises were approved by MOFCOM, out of which 625 are wholly foreign-owned. In the top 100 retailers' list, 27 were foreign-invested, including Carrefour, METRO, Tesco, Tricon, Wal-Mart and Parkson. The combined sales of these foreign-invested retail operations totalled RMB261.9 billion (USD32 billion) in 2005, accounting for 37% of the total sales of the top 100 chain enterprises.

The rapid development of chain operation and the rise of modern retail formats are transforming the retail landscape in China. Supermarkets, hypermarkets and convenience stores are increasingly become the favoured venues for consumers shopping for their groceries and food.

The development and spread of the sector has been very impressive. The Shanghai-based Brilliance Group (formerly known as Baillan Group), the largest supermarket chain operator in China, added 845 stores in 2005, bringing the total number of stores to 6,345. Wumart Stores, Beijing's largest supermarket chain, also accelerated its expansion and has extended its retail network in Beijing, Tianjin and Hebei Province.

With the proliferation of supermarkets of all sizes and descriptions, intense competition is driving inefficient operators out of the market. At the same time, many retailers, including strong regional players, want to exit or sell out. Vanguard's purchase of Cikelong Supermarket and Tianjin Yuetan Supermarket and Beijing Hualian's acquisition of 51% of Guangxi Jieyong are recent examples. Larger players also try to forge strategic cooperation via alliances. For example, in December 2005, Brilliance Group and Dashang Group agreed to set up a third company together with the objective to strengthen the two companies' position in the retail sector.

In February 2006, Beijing Hualian announced its acquisition of the Singapore branch of Japan-based retail operator, Seiyu. This may mark the beginning of a trend for Chinese retailers to expand overseas via merger and acquisition.



China

Hypermarkets Development led by international retailers

Key domestic food retailers (2005)

Company	Sales (USD bn)		Number of outlets	
	Total	Growth (%)	Total	Growth (%)
Brilliance Group	8.8	7.2	6,345	15.4
CR Vanguard	3.8	26.0	2,133	20.0
Dashang Group	3.7	30.5	130	8.3
Beijing Hualian	2.5	30.0	74	5.7
Wumart	2.3	43.6	659	8.4

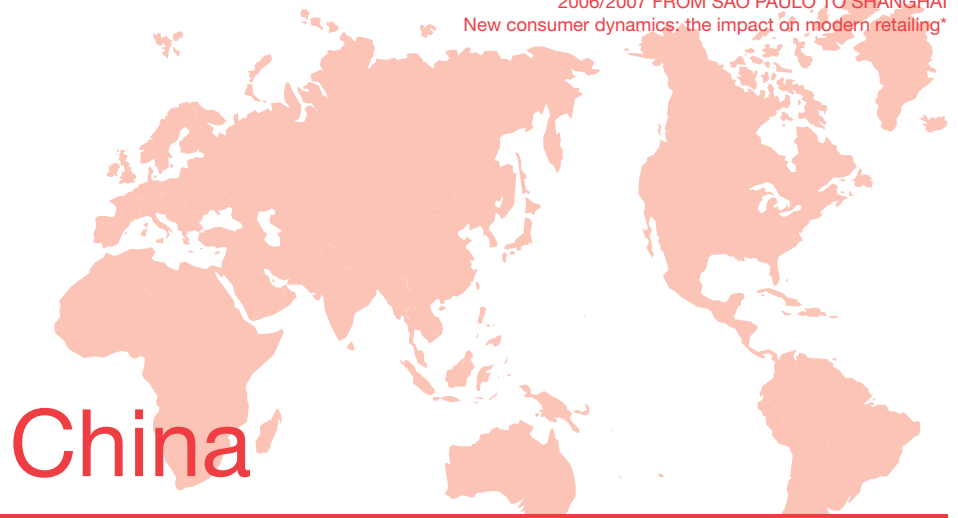
Source: China Chain Store and Franchise Association

The top 10 largest foreign operators have around 475 stores in total, with a combined turnover of RMB93.7 billion (USD11.43 billion) in 2005. The largest foreign hypermarket operators include Carrefour, Wal-Mart, Tesco, Auchan and Lotus.

With market saturation in first-tier cities, hypermarket operators are looking for expansion in lower-tier cities and the inland regions. For example, Carrefour, the top foreign retailer in China with sales of RMB17.4 billion (USD2.12 billion) in 2005, has plans to open around 20 new hypermarkets. The new store locations include Zhengzhou in Henan province, Urumiqi in Xinjiang and Kuming in west China, while Wal-Mart is focusing on smaller urban centres such as Foshan, Mianyang, Nanhai and Wuhu. Tesco is extending its market reach to Dalian, Hangzhou, Ningbo, Shenyang, Tianjin and Shanghai through acquisition of an established hypermarket operator, Hymall in China. Thailand-based Lotus has started to expand to mid-sized cities like Huaian and Kunshan in Jiangsu province and Jiangmen in Guangdong province.

With the removal of restriction on ownership, coupled with their localisation strategies, some foreign retailers are buying out their Chinese joint venture partners. For instance, Carrefour acquired the 35% holding of its joint venture partner, Kunming Department Store, in October 2005, in addition to establishing a WFOE in Shenzhen. Other global retailers such as METRO and Lotus are also contemplating buying out their local partners.

On the other hand, to remain competitive, innovation in product and service offerings is vital to attract consumers. Wal-Mart, for example, is offering more fresh produce and includes fast food counters to offer breakfast, lunch and dinner to busy shoppers.



China

Convenience stores
Concentrated demand in urban areas

Discount stores
A nascent segment in major cities

Key foreign food retailers (2005)

Company	Home country	Sales (USD m)	Number of hypermarkets
Carrefour	France	2,127.7	70
RT-Mart	Taiwan	1,915.9	60
Trust Mart	Taiwan	1,610.8	105
Lotus	Thailand	1,227.6	61
Wal-Mart	USA	1,212.2	56
Tesco	UK	966.5	39
METRO	Germany	920.9	27
Auchan	France	610.2	13
Makro	The Netherlands	122.0	5

Source: China Chain Store and Franchise Association

Development of the format is most dynamic in Shanghai and Guangdong, but otherwise sporadic across China. The sector comprises mainly domestic chains, such as Quick of Lianhua and Alldays and Kedi of Nong Gong Shang. Foreign players include 7-Eleven, Lawson, FamilyMart and Circle K. Because of the proliferation of convenience stores, competition is intense and net margins are squeezed.

Some global retailers are starting to adopt a multi-format strategy and include convenience stores in their operation in a bid to capitalise on the growing demand for convenience from urban consumers.

The discount store first appeared in China in 2003, as introduced by Carrefour under its fascia, DIA. In a joint venture with leading domestic retailer, Shanghai Lianhua Supermarket, Carrefour has opened some 250 DIA stores in Shanghai. Goods sold through these discount stores are mostly private label merchandise and are priced more competitively than in hypermarkets. This format is still in the development stage in China and is confined to Tier I cities.



Non-food retail channels

Department stores
Evolving to stay competitive

Once a popular retail format in China, department stores are being marginalised by modern retail formats. To survive and stay competitive, many established department stores in major cities such as Beijing and Shanghai have to reinvent themselves in various ways, such as focusing on mid and high-end customers or incorporating different kinds of retail formats like supermarket and specialty counters in the store.

Department stores that have made the Top 100 Chain Enterprises list include Parkson (Malaysia), Hefei Department Store, Beijing Wanfujing Department Stores and Shenzhen Tunglowan Department Store. Other foreign operators include Pacific Department Store (Taiwan), Robinson (Philippines) and JUSCO (Japan).

The MOFCOM announced in May 2006 that department stores would be rated into three levels, namely Gold, Silver and Bronze according to scores based on retail space, product mix, shopping environment, management, service, credibility and other criteria. The rating scheme would first be tried out in the nine cities of Beijing, Tianjin, Shanghai, Chongqing, Dalian, Nanjin, Changsha, Qingdao and Xian. It is believed that MOFCOM's move is an attempt to revive the appeal of department stores to woo customers that are drifting away to other modern retail formats.

Key department stores (2005)

Store brand	Sales (USD m)	Growth (%)	Number of stores	Growth (%)
Parkson Department Store	1,342.4	49	36	20
Hefei Department Store	1,281.3	44	54	29
Wanfujing Department Store	790.0	22	14	8

Source: China Chain Store and Franchise Association

Specialty stores remain popular

Specialty stores specialising in one type of product or service continue to flourish in China. For example, in 2005, specialty stores included in China's Top 30 Chain Enterprises recorded annual sales revenue growth of 60.7% year-on-year and saw the number of stores increased by 50.8%.



China

Consumer electronics and
appliances
*In demand from middle-
class consumers*

The top retailers in the sector are domestic players, namely Gome, Suning, Yongle, Five Stars and Sanlian. Foreign investment in this domestically dominated sector is very low. Consumer electronics sales are projected to grow by more than 10% annually for the next decade, reaching USD100 billion in 2010.

Best Buy of USA eventually confirmed its first move into the Chinese market in May 2006. Best Buy agreed to purchase a controlling stake in China's fourth largest electronics and appliances retailer, Five Stars. The acquisition would give Best Buy access to 136 stores in eight provinces.

Gome is the market leader, with 426 stores in 88 cities. Listed in Hong Kong, Gome also operates six stores there. To expand its retail network, in particular in new regions, Gome is on the acquisition trail in 2005 – Black Swan Appliance in Heilongjiang, E-home Chain Store in Shenzhen and Wuhan Zhongshang Commercial Group in Hebei. Gome's latest acquisition in mid-2006 is its third largest rival in the sector, Yongle, thereby bringing the number of stores to over 625 and consolidating its market leader position further.

Key consumer electronics and appliance retailers (2005)

Company	Sales (USD bn)		Number of stores	
	2005	2004	2005	2004
Gome	6.08	2.90	426	227
Suning	4.85	2.67	363	193
Yongle	1.85	1.32	199	108
Five Stars	1.78	1.14	193	120
Sanlian	1.61	1.61	274	254

Source: China Chain Store and Franchise Association

Home goods and furnishings
*Home ownership has
increased market*

Even though the sector is still fragmented and is made up of independent stores each offering a particular product such as kitchen fixtures and baths, a number of foreign and domestic home goods retailers have opened stores to target the middle class and educated professionals.

B&Q has been in China since 1999. In April 2005, it acquired the 13 stores of OBI, another foreign home improvement retailer that had exited the Chinese market because of problems with its local partner. B&Q also opened stores in Chongqing, Dalian, Dongguan, Xian and Xiamen. The total number of stores rose to 48, and B&Q plans to have 100 outlets in China by 2010.



China

IKEA, on the other hand, is expanding its presence in China more gradually. It has two outlets in Shanghai and Beijing, with another store under construction in Wangjing, a new residential district in northern Beijing. Another store is planned to be set up in Kunming. IKEA revealed that China is the top purchasing choice for the company, with 18% of its purchasing fund allocated to China.

US-based Home Depot gained Chinese government approval in 2005 to invest USD15.5 million in opening stores in the country. It is reported that the company is planning to set up a wholly owned company, rather than using acquisition to establish itself in China.

Key home goods and furnishing retailers (2005)

Store brand	Sales (USD m)	Growth (%)	Number of stores	Growth (%)
Home World	1,124.8	28	82	30
Orient Home	735.2	15	27	23
B&Q	629.7	156	48	129

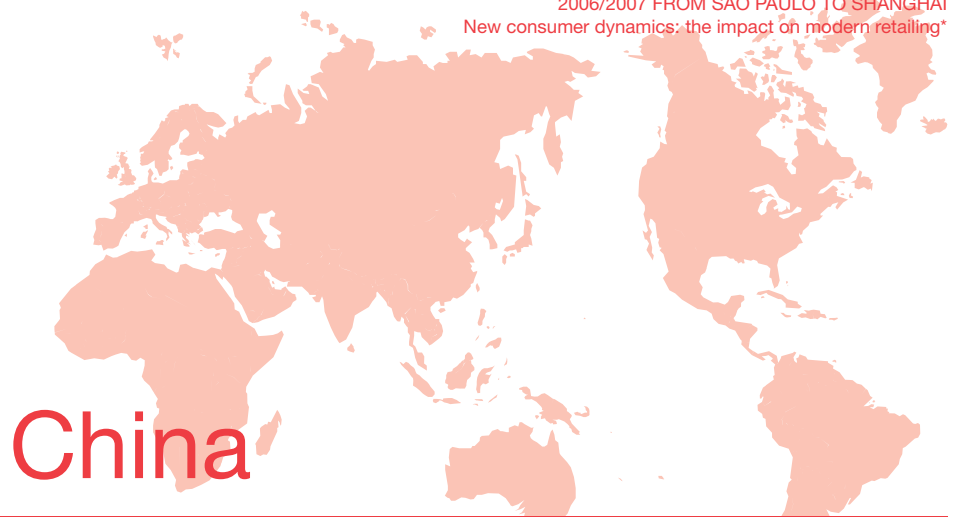
Source: China Chain Store and Franchise Association

Clothing and apparel Sales continue to grow

The total sales of clothing in China in 2004 exceeded RMB562 billion (USD67.9 billion) and the figure is expected to grow further with increasing per capita income and rising consumer aspiration. Despite being the manufacturing base for many of the world's biggest and most famous apparel brands, China has yet to come up with any major brands of its own. Li Ning (sports wear), Daphne (footwear), Boton (leisure wear) and Gujin (underwear) are the handful of domestic brands that have national market reach in their respective categories.

Early foreign entrants to this sector are mainly from Hong Kong, with brands like Esprit, Giordano, Bossini, Baleno and Glorious Sun. These brands are considered foreign brands, upscale and yet not luxury, and therefore have a strong appeal to middle-market consumers.

Prior to the liberalisation of the distribution sector in December 2004, medium-sized foreign apparel chains, except for a few foreign premium fashion brands, were restricted in entry to China's massive apparel market because of stringent requirements. The post-liberalisation scenario has attracted many middle-market apparel brands to China, including Zara and Mango from Spain, Etam and Kookai from France, UNIQLO from Japan, La Senza from Canada and Tommy Hilfiger and Jockey from the US.



Luxury goods
A strong segment

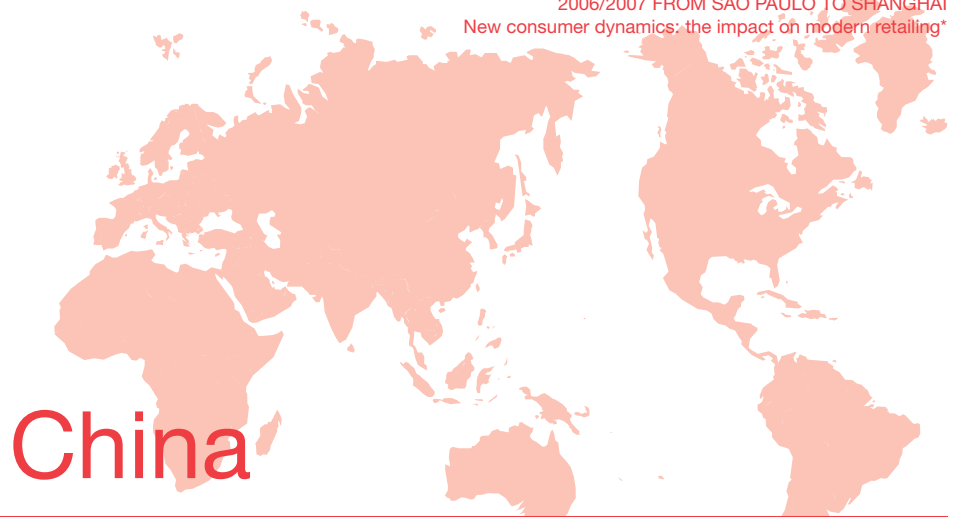
Amid this influx of stronger foreign players (from a fashion point of view), the stronghold of the early entrants from Hong Kong, which focus almost entirely on casual wear, is being challenged. In response, Giordano has gone upmarket with the launch of Giordano Ladies in order to seek a market niche. Esprit, on the other hand, has been offering the same merchandise in China as what is offered globally, with strong European tilt, and therefore has managed to keep its appeal among young, professional class consumers.

China's luxury goods market currently generated more than USD2 billion in sales a year. It is expected to grow 20% annually until 2008 and then 10% annually until 2010, with sales exceeding USD11.5 billion.

The promising market prospect is highlighted by the premium brands that have established a presence and are expanding, not only in first-tier cities but also venturing into lesser known ones. For example:

- Louis Vuitton – has more than 10 stores across China, including second-tier cities such as Xian, Xiamen and Qingdao; China accounts for 10% of its worldwide sales
- Cartier – has 12 stores in nine cities across China. By 2010, this will have increased to almost 30 and China will have overtaken Japan as its second biggest market in the world
- Giorgio Armani – rolled out its flagship store in Shanghai in 2004 and plans to open 30 stores in major cities by 2008
- Gucci – has seven stores and plans to add another 10 over the next three years
- Montblanc – has four boutiques and over 80 point of sale in 40 cities across China
- Prada – with 22 outlets, is building a flagship store in Shanghai

Industry analysts estimate that Chinese consumers, including residents of Hong Kong, now represent the third biggest luxury goods market worldwide, accounting for about 12% of global sales, and predict that the Chinese could overtake the Japanese as the world's top consumer in 10 years' time.



Alternative retail channels

Franchising

A means for regional penetration

China has 1,900 franchise systems, with 822,000 outlets and is growing at 40% annually. Franchise brands number about 2000, covering a diversity of products and services. At present, franchising business accounts for only 3% of China's total retail sales and has huge potential for further growth. Foreign franchisers in China include KFC, McDonald's, 7-Eleven, Pizza Hut, Athlete's Foot, Häagen-Dazs, etc.

Direct selling

Potential for further growth

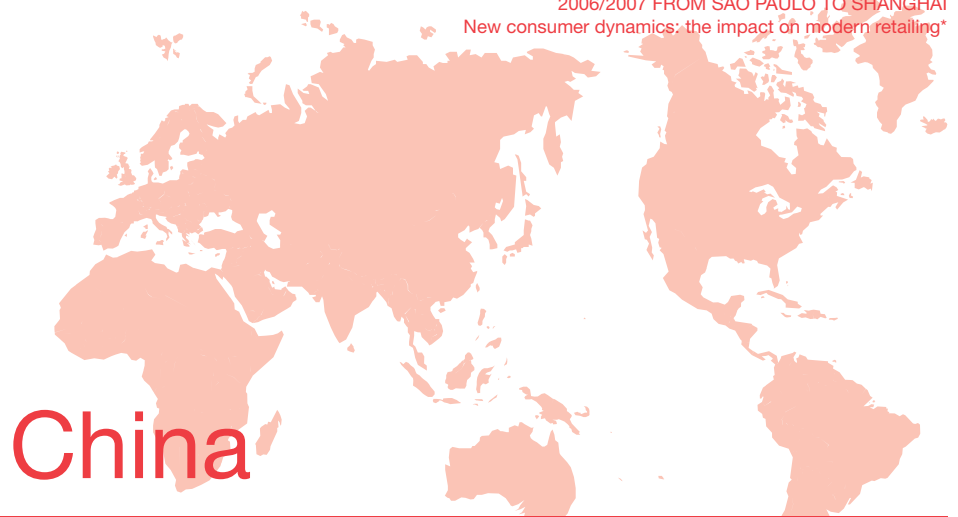
Despite the fact that significant questions remain, the introduction of the direct selling rules in 2005 has provided the legal framework for direct selling operators to tap into China's retail market. Foreign companies now maintaining substantial market presence in China include Amway (personal care), Mary Kay (cosmetics), Avon (cosmetics), Nu Skin (personal care) and Sunrider (herbal products, vitamins). The potential of direct selling is believed to be bright; for example, Avon predicted 60% annual growth through 2007.

Online retailing

A new route to consumers

In China, there are 119 million Internet users, 916 Internet service providers and 14,000 content providers in 2006. The transaction volume of B2C shopping in 2004 was RMB4.2 billion (USD507.4million) and in 2005 the figure increased to RMB5.6 billion (USD683 million), a growth of 33%. It is reported that there are more than 20 million online shoppers in the country, and more than half of them use online payment.

It is forecast that the number of Internet users will increase to 178 million by the end of 2007. With the maturing payment and credit system and the rising computer-savvy young population, online retailing presents a viable alternative route to reach China's consumers.



RETAIL AND CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

CHALLENGES

Sourcing – buyers beware

Global retailers' sourcing from China is one of the factors driving the rapid growth of China's export of consumer products. Wal-Mart, Carrefour, METRO and Auchan, the top four foreign retailing giants in China, together have purchased over USD27 billion worth of goods from China in 2005.

However, the evolving international trade situation sometimes may throw up unexpected surprises that create risks in sourcing. For instance, the turn of events after the end of textile quotas in 2005 had caught a number of companies, including C&A, Liz Claiborne and Wal-Mart, that sourced apparel from China off guard and highlighted the need for global retailers and suppliers to take into account of risks such as these and have ready alternatives in their sourcing. Hong Kong is one of the options that companies should consider as Hong Kong-based apparel producers with production plants in China are eligible for "outward processing arrangement" that is not subject to quota restriction on China.

Another lesson learnt is that retailers and suppliers must choose their third-party sourcing agent with care. Li & Fung, the industry's largest agent and heavily involved in textile sourcing in China, came through the incident without any effect on their performance as the company had foreseen the likely scenario and was well prepared ahead. This is the kind of standard that global retailers and suppliers must look for in their sourcing agents.

Supply chain

Despite vast improvement, China's underdeveloped distribution infrastructure and fragmented retail markets pose huge challenges to FMCG companies trying to penetrate lower-tier cities. With the liberalisation of the distribution sector and the aggressive expansion of leading foreign retailers, FMCG companies will find it easier to ride on the back of these developments to gain access to lower-tier markets. Companies such as Coca-Cola and Nestlé are investing in their own distribution systems and bringing in new technology and management know-how as a solution.

Another major constraint in distribution efficiency is the lack of cold storage warehousing, limited refrigerator carriers and efficient methods of food preservation and packaging.



China

In most parts of China, distribution infrastructure remains underdeveloped. Despite government efforts in upgrading and extending the country's infrastructure, supply chain-related costs remain higher than elsewhere: about 20% of product price compared with 10% in the US, as US Commerce Department points out.

Inefficient supply chains will create additional hurdles and strain on the system for retailers and suppliers in their expansion beyond the first-tier cities. The serious shortage of logistics professionals and the lack of qualified distributors further exacerbate the problem.

The opening of the logistics sector under the WTO liberalisation measures as well as under CEPA will alleviate the situation to a certain extent. As such, it is estimated that the market share for third-party logistics service providers would grow from the current 3% to 20% by 2010, with a market value of USD30 billion. However, for the near term, infrastructure and logistics constraints will remain very real issues and can only be addressed over time.

Currency revaluation

Under international trade pressure, China is expected to continue building the mechanism needed to float the Renminbi which will be re-valued upwards further. However, the currency appreciation will be gradual to avert drastic impact of the country's import and export. For retailers and suppliers buying from China, this will mean high prices for their sourced merchandise and this must be factored in any sourcing budget. Yet, looking at it from a positive angle, currency appreciation would make Chinese consumers richer and able to purchase more products from the West.

EMERGING TRENDS AND OPPORTUNITIES

Moving to secondary cities

Foreign retailers are following close on the heels of rising economic prosperity in the lower-tier cities and are opening new stores in places such as Chengdu, Chongqing and Shenyang.

For example, Carrefour has relocated its regional headquarters for central and western China to Chengdu as part of its strategy to secure a foothold in China's western region. Wal-Mart is reported to be in negotiation with 10 second-tier cities, including Jinhua in Zhejiang and Wuhu in Anhui, about setting up new stores in these cities. METRO, on the other hand, is focusing on Dalian, Shenyang Harbin and Changchun in China's northeast.



China

Mergers and acquisitions

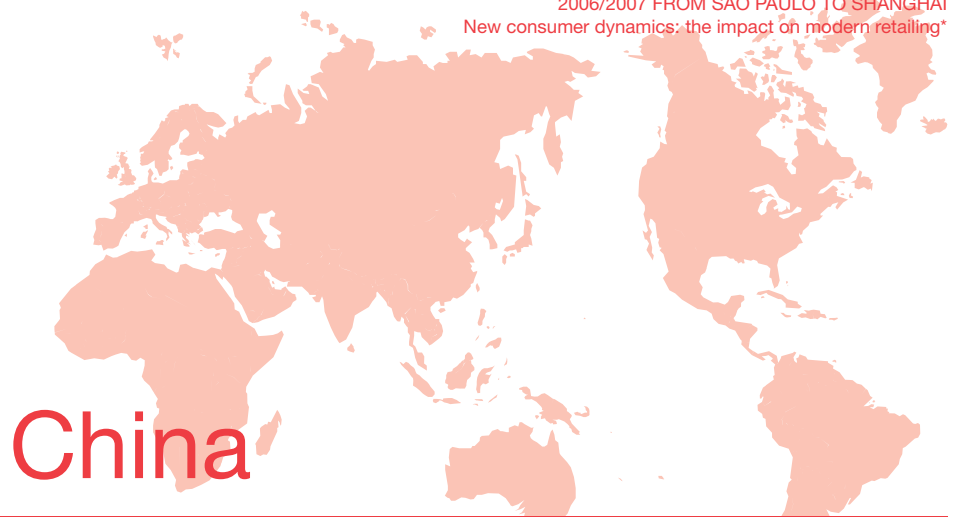
Opportunities also abound in the smaller cities in the Pearl River Delta (PRD) and Yangtze River Delta (YRD). Foreign retailers are well advised not to lose sight of these economically vibrant cities. Take the example of Foshan and Dongguan, two of the most prosperous cities alongside Guangzhou and Shenzhen in the PRD. Per capita GDP in each was over RMB40,000 (USD4,833) in 2003. In 2004, GDP of Foshan was RMB165.3 billion (USD20 billion) and Dongguan RMB115.5 billion (USD13.95 billion). A similarly robust picture is presented by cities such as Kunshan, Suzhou, Wuxi and Tongling in the YRD.

M&A activities are expected to continue in the coming few years. For foreign retailers, M&A can be a fast means of gaining market entry as in the case of Tesco, or penetrate new markets and extend network in other regions as in the case of B&Q. In June 2006, Belgian brewer InBev completed its acquisition of Fujian Sedrin Brewery in China and a wholly-foreign-owned enterprise, InBev Sedrin, has been established. This RMB5,886 million (USD717.8 million) acquisition, combined with InBev's existing operations in China, positions InBev as one of the largest brewers in the country.

Recently, France's SEB, the maker of Tefal non-stick saucepans, announced the proposed acquisition of majority shareholding in Zhejiang Supor Cookware Co. Ltd., China's biggest company in the field. Italy-based appliance maker Candy Group had signed an agreement to acquire 75% of Jinling Electrical Co. Ltd., a washing machine manufacturer that is the third ranking brand in the China market. Even though, at the time of writing this report, these deals are still subject to approval by the Chinese government, they represent a growing trend in foreign acquisition of Chinese companies as a fast track to market entry and expanded activities.

For domestic players, market consolidation will be achieved through M&A. Stronger players may use this to buy out smaller retailers in regions where they want to extend their presence. Domestic retailers may also make use of M&A in other countries, such as the example of Beijing Hualian's acquisition of Seiyu in Singapore, as a way to breach into overseas markets.

Following the announcement of a new set of supplementary rules by MOFCOM in July 2006, the permitted scope of foreign investment in China is further extended. Foreign-funded investment companies are now permitted to undertake service outsourcing activities for offshore companies and their exports are eligible for export tax rebate. The supplementary rules also encourage foreign investors to undertake M&A of domestic enterprises.



Strategic alliances and voluntary chains

In future, more retailers are also likely to collaborate with companies providing retail-related ancillary services such as logistics and warehousing as a means of better managing the supply chain.

Forming strategic alliances among retailers to establish long-term strategic expansion and leverage on each other's strengths is expected to be more common in the coming years. The recent alliance and cooperation between Brilliance and Dashang may set the trend.

Small and medium-sized domestic retailers have started to form voluntary chain operations to counter the intensified competition through enlarged bargaining power, pooling of resources, enhanced sourcing capabilities and sharing of logistics facilities and information. International chain operators, SPAR and IGA moved in to China in 2005.

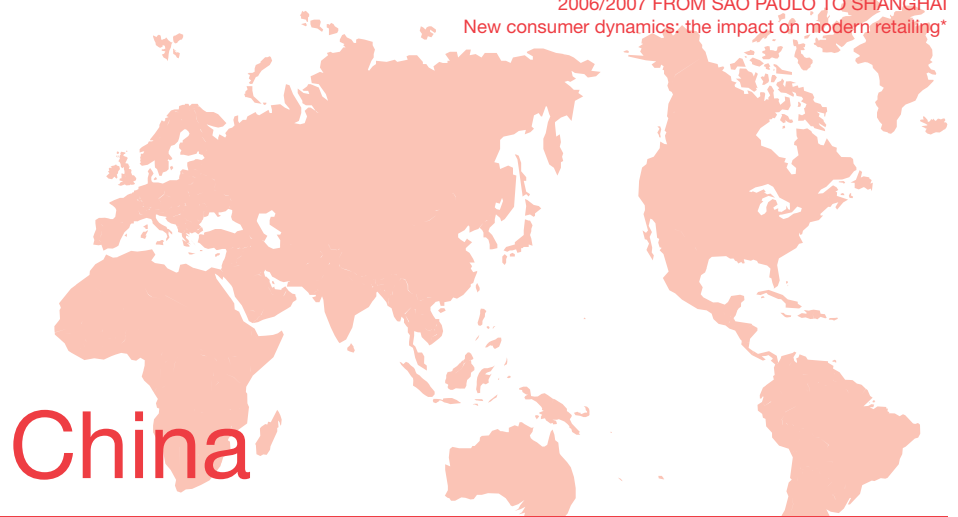
SPAR is focusing on second-tier cities in Shandong, Henan, Hubei and Anhui in central eastern China. The first SPAR hypermarket with local partner Jia Jia Yue Supermarket in Weihai, Shandong was opened in 2005 and proved to be hugely successful. SPAR has plans for 15 SPAR hypermarkets in Shandong in three years.

IGA also made its debut in China in 2005 and has five members so far, namely Shenzhen Yourong and Ningbo Sanjiang in south China, Hunan Bubugao and Hubei Zhongbai in central China, and Heilongjiang Qikelong in the northeast. IGA encourages members to continue using their own brands while providing management and operation know-how to members.

The concept of voluntary chain operation has received official government support and generated immense interest among independent domestic retail operators. Further expansion of this business model is likely in the future.

Rural market – a land of opportunity

The central government's ambitious programme announced in February 2005 to build a national rural retail network covering 70% of all villages within three years will open up huge opportunities for retail chain operators. The promised distribution infrastructure improvement, preferential treatment and support from local governments will pave the way for retailers to the hitherto untapped rural market. The programme, however, is not aiming at encouraging the opening of new stores in the rural market, but rather to entice participating retailers to take over or cooperate with existing rural stores by means of



Brand building

franchising or voluntary chain operation. In a way, this will help to reduce set-up cost and minimise conflict with local retail operators and consumers for the participating retailers. If successful, the programme would see around 250,000 supermarkets and convenience stores chains in the counties and major towns and villages by 2008.

Despite its robust retail and consumer market development, China has only a handful of international and national brands. Haier and Lenovo (consumer electronics and appliances) and Qingdao (beer) are the better known ones. The central government is keen to aid large domestic companies to build up their brands, but the emergence of extensive national brands will still be some time in the future.

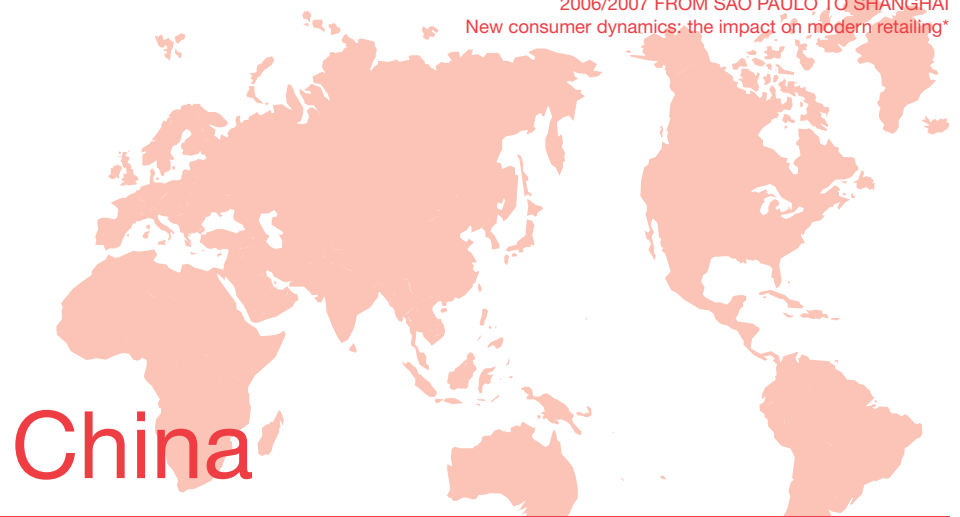
However, given the Chinese consumers' strong preference for foreign brands and that this preference is attracting a host of brands to the market, foreign retail and consumer companies must be vigilant in brand building to keep from being smothered.

Brand building launches will call for effective and innovative marketing in order to succeed. Eastman Kodak, one of the official sponsors of the 2008 Olympic Games, launched an innovative marketing campaign by giving away free cameras to people in remote regions such as Gansu. This has the benefits of not only being a high-profile marketing stint but also presenting an enthusiastic response to the government's call for enterprises to go west.

Private Labels

Developing private label, in conjunction with localisation of products, has been adopted by a number of foreign retail and consumer companies. For instance, Carrefour has launched 435 private label products in its stores across 23 Chinese cities last year. The Hong Kong-based chain, AS Watson, offers over 1,000 private label products in China, about 20% of its total product offerings. These lower-priced products are in general well-received by the price-conscious Chinese consumers.

With the expansion of the global retailers and the increasing brand-building capabilities of domestic retailers, private label products offering is expected to grow further in the coming years.



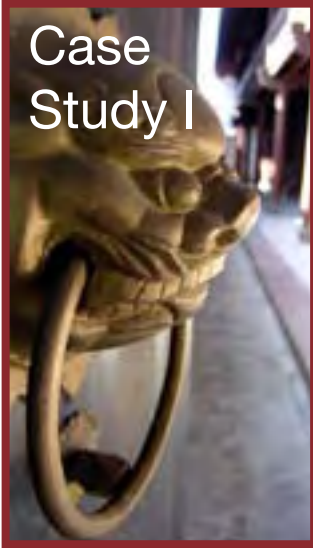
Research and development centres

Global retailers and suppliers are increasingly establishing R&D centres in China. For instance, Johnson & Johnson recently set up a consumer goods R&D and innovation centre in Shanghai, which is the company's largest R&D centre in the Asia-Pacific region. Estée Lauder opened a research centre in Shanghai in 2005 primarily to research on Chinese medicine, but it is believed that the company would also like to make use of the facility to study Chinese consumer behaviour. As a part of its strategy for expansion, Danone has recently opened a research centre for fresh dairy products in Shanghai. It has three others, one of which is dedicated to the biscuits business and the remaining two to beverages.

R&D centres were established by foreign investors in China in as early as 1980s, but these operations were focused mostly on product localisation. However, since the 1990s, multinational companies have invested over USD4 billion into some 750 R&D centres. A survey on the world's top 300 R&D spenders by the United Nation Commission on Trade and Development reported that over 61% of the respondents indicated that China would be their R&D destination in the coming years.

In addition to product localisation, nowadays these R&D centres increasingly are also generating innovative products with global application. The growing pool of university graduates in science and engineering in China and the government's keen support on high-tech R&D through tax concession and other incentives are some of the reasons driving the R&D trend.

Case Study I



Li & Fung Limited: From traditional Asian trading company to global supply chain manager

KEY DRIVERS

Li & Fung Limited, set up in China 100 years ago and now headquartered in Hong Kong, is a leading global consumer goods sourcing company managing the supply chain for retailers and brands world wide through a network of over 70 sourcing offices in over 40 countries and territories. How has a family business succeeded in changing to become a global player with a lead position on the market?

Background

Victor and William Fung, grandsons of the founder, now head the company and both had studied at the Harvard Business School. The Fung brothers are instrumental in transforming a family business into a global conglomerate while retaining some dimensions of Eastern traditional value in the operation of the company. In the words of the Fung brothers, Li & Fung is a Chinese company with Western characteristics – Western in management and business model and Eastern in attaching great value in relationships and entrepreneurship.

Garments make up a large part of the Li & Fung's business, which also covers the sourcing of hard goods such as fashion accessories, toys, gifts, home goods, promotional merchandise and others. Turnover of the company for the year 2005 was HK\$55.6 billion (USD7.2 billion), an increase of 18% over the previous year and profit attributable to shareholders was HKD1.79 billion (USD230 million). The company owns no production facilities but instead an internally vetted global network of 7,500 suppliers worldwide that are quality-conscious and cost-effective to ensure on-time delivery to its customers.

Transforming the company

In the early years of the company, Li & Fung was principally a broker, charging a fee for putting sellers and buyers together. In the late 1970s, the company developed into a regional sourcing agent and set up offices in Taiwan, Korea and Singapore, leveraging its knowledge of the region, such as textile quotas and the strengths of each country in terms of product quality, to increase value for customers.

In the second stage of development in the 1980s, Li & Fung extended its sourcing agent strategy further and began to manage and deliver manufacturing programmes. For instance, based on customer-provided apparel designs, the company would create an entire programme with prototypes with the right fabric and in the right colours for the whole season, specifying the product

mix and schedule. The company also monitored and supervised the production in factories to ensure quality and on-time delivery.

The emergence of the Asian tigers in the early 1990s propelled Li & Fung to another stage in its development. Hong Kong then had become too expensive to be competitive in manufacturing. Fortunately, China began to open up to trade, thus enabling many Hong Kong manufacturers to shift the labour-intensive part in their production to southern China to address the cost problem. Li & Fung adopted what itself described as “virtual manufacturing” in that the value chain was broken up: the labour-intensive middle part of value chain was carried out in southern China, while the headquarter and its major sourcing and marketing offices handled the front end such as product design and production planning and back end, such as quality control and shipping.

Since then, Li & Fung has developed into a leading supply chain manager for many global retailers, extending its geographical reach and service offerings. The success factors in Li & Fung's evolution from traditional agency business into a global supply chain manager lie in the company's focused strategy in positioning itself as a supply chain manager, the integration of operational strategy with its organisational strategies, customer-centric organisational structure, information technology initiatives and globalisation efforts.

Supply chain manager positioning

Dispersed manufacturing

Li & Fung instituted the innovative process of breaking up the supply chain into various stages of manufacturing and choosing the factories, locations and countries assigned for each stage according to their best competitive advantages. For example, an order of shirts from a retailer in the US may be disaggregated such that the yarn would be sourced from one country and then dyed and woven in some other factories in a second country. The tailoring of the shirts may be carried out in other factories in a third country. The factors that determine the location and

client's needs, timing, capacity, technology requirements, labour and required skills. Li & Fung would undertake quality control and testing at the back end of the value chain. By the time the finished products reached the retailer in the US, they would look as if they all come from the same factory, when in fact a number of factories in three countries have been involved in the value chain.

Total Value-Added Package

For each customer order, Li & Fung would have a customised value chain and provide a one-stop shop service for the customer through a total value-added package and bring the retailers and manufacturers closer in collaboration.

Take the typical order of shirts again. Li & Fung would offer front end services in product design and development and production planning, preparing prototypes of the product in the process. Upon customer feedback, the company would move upstream to organise the production for the customer. In this middle part of the supply chain, Li & Fung would add value by taking charge of the whole production process, from raw material sourcing, selecting the manufacturer to providing management expertise and technical know-how.

The company helps the customer to buy "closer to the market" by virtue of its extensive network of global suppliers and the trust built between the company and the suppliers. Retailers of time-sensitive products such as fashion can wait until they are more certain of the fashion trend before they commit themselves to any order, while in the meantime Li & Fung has already had the required material for the season sourced and the producers of the final product standing by and ready to deliver. This would shorten the customer's buying cycle considerably, in turn translating it into better inventory management and lower markdown in stores.

Tackling the "soft cost"

Li & Fung reckons that manufacturing costs typically comprise just about 25 per cent of a product's price, while "soft costs", such as transportation and warehousing, make up the remaining 75 per cent. To tackle the soft costs, Li & Fung would adopt relatively unconventional steps in logistics and distribution, making savings as the ultimate goal.

Operational and organisational strategy integration

Geographical spread with operating agility

Given the spread of operations in so many countries, Li & Fung's organisational structure is such that the product group managers who are located in different locations are responsible for the day-to-day operations. These managers meet twice a year to discuss on strategic business issues. In addition to this, a policy committee, formed by these managers and the top management meet face-to-face regularly to discuss and agree on policies such as compliance and social responsibilities.

The committee then translates the policies into operating procedures and the product group managers will be the vehicles for implementing these procedures in their respective locations.

Flexible client-servicing units

To maintain flexibility and prevent the company becoming bureaucratic, the basic operating unit of Li & Fung is the division, which consists of small team of staff dedicated to handle one customer or a number of smaller customers with similar needs. To encourage entrepreneurial spirit, each division head is given extensive autonomy and considerable operating freedom in running the division, in a manner similar to running his or her own business. As motivation, the compensation of the division head is tied to the profitability of the division.

Central financial control

Financial controls and operating procedures, however, are managed and controlled centrally, and so are working capital and cash flow. The Fung brothers admit that this approach is much more conservative in contrast to the company's aggressive merchandising.

Customer-centric organisational structure

One customer, one division

Li & Fung structures its organisation around the customer. One division is deployed for one customer or a group of smaller customers with similar needs. Each division has its own sourcing teams in various countries, depending on the needs of its customer. These country-based sourcing teams work in branch offices of the company but report to the division head.

Specialised teams

Staff in a division is organised into specialised teams in areas such as technical support, merchandising, material sourcing, quality control and shipping, in other words, a customised value chain for each customer order. Each division effectively becomes the product development, procurement and logistics arm of the retailer, thus saving time and cost for the customer.

Customer relationship

Li & Fung retains a traditional dimension in its customer relationships. The Fung brothers endeavour to remain well informed of the company's customers and keep a personal touch with them, in the tradition of their grandfather and father. At the same time, relationship with suppliers is also built on trust and the company's long-standing record of honouring commitments.

Embracing information technology

- Li & Fung sees the importance of information technology (IT) as it provides connectivity to its extensive supply chain network and provides customised, quality support for customers and their time-sensitive needs.
- The company has a standardised, computerised operating system for executing and tracking orders and all employees in the company have access to the system
- Each staff member in a client-servicing division has a direct software link to the customer that the division serves, thus enabling efficient connectivity, communication and compatibility with the customer.
- Li & Fung also tracks supplier relationship in a database so that the performance record of any particular supplier is at the fingertips of the staff.

Globalisation and diversification

Acquisitions

Throughout the years, one of the key strategies of Li & Fung has been to carry out a series of smaller acquisitions to augment capabilities in sectors that the company would like to see expansion or coverage. For example, in 2005 the company acquired a corporate promotional products supply company in Europe, an apparel company with 40 character brand licences in the US, an apparel company focused on supplying private labels to mass-market retailers and a furniture sourcing agency business in Indonesia.

Acquisition and integration of various businesses in different parts of the world have enabled Li & Fung to expand its presence and enlarge its diversity in product mix, geographical coverage and customer base.

Diversification

The company's diversification strategy enables it to open up new customer segments and opportunities. For example, in 2003, the company started to build a brand business in the US as an extension of its role in the supply chain. Since then, its brand licensing business has extended to include some of the world's largest brands, such as Levi Strauss, Royal Velvet and Disney.

Among other new business ventures is the building of an onshore US business in private labels, licensed brands and proprietary brands. For example, in mid 2006, the company acquired two women's apparel and handbags business, Oxford Womenswear Group and Rosetti Handbags and Accessories, which license and sell private labels for major US retailers. The company leverages its core competency on the direct offshore sourcing model to service retailers preferring to conduct business on an on-shore basis. The licensed brands business developed in 2003/2004 would provide the basis for supplying branded goods to suppliers. Leveraging its capabilities in private labels and licensed brands areas, the company would be able to extend its coverage to proprietary brands, building exclusive lines of merchandise on nationally known brands for retailers.

Key takeaways

In essence, innovation, differentiation, diversification and customisation are the key factors in the success of Li & Fung in maintaining its leadership position in the domestic market while emerging as a global player.

Case Study II

Procter & Gamble – Growing through innovation and collaboration

KEY DRIVERS

Unlike retail and distribution, the Fast Moving Consumer Goods industry in China has been open since the end of the 1980s when a host of leading global companies entered the market. P&G was one of these early entrants. P&G established its first joint venture in Guangzhou in 1988. At present, P&G has operations in multiple locations including Guangzhou, Beijing, Chengdu and Tianjin, with cumulative investment over USD1 billion. P&G also has plants, distribution centres and sales branch offices in major cities in China, while its product selling covers more than 500 cities in the country. How has the company built its position as a market leader over the past 18 years?

Background

Since its entry in 1988, P&G has brought to China such brands as Crest, Rejoice, Head & Shoulders, Safeguard, Olay, Whisper, Pampers, Ariel and Tide. P&G's rapid business growth in China has been achieved through focused product portfolio, innovation and local adaptation, and supplier/retailer collaboration.

Focused product portfolio

When P&G entered the Chinese market, it began with a sole focus on establishing its shampoo market, backed up with massive advertising efforts. Faced with little domestic competition, P&G, and other foreign FMCG companies, found it relatively easy to sell their products. Despite this, P&G was careful to ensure that it had firmly established its market position in shampoo before broadening its portfolio of products into personal and household care sectors. With this focused strategy, P&G was able to apply the lessons learnt in launching its shampoo to other product lines as it brought them to the market.

However, as Chinese FMCG companies caught up on manufacturing in shampoo and many other FMCG products, market overcapacity changed foreign companies' hold on the market. Domestic shampoo brands were much lower in price and soon were snatching market share from foreign ones. In order to maintain a successful hold on the shampoo market share, P&G strove to obtain a clearer understanding of the market and a more defined identification of consumer segments by collecting consumer data. As a result, P&G created four strong brands and spent heavily on advertising to establish separate identities for each shampoo product range – Vidal Sasson for fashion, Pantene for healthy hair, Rejoice for soft and beauty, and Head & Shoulder for dandruff. These efforts on clear differentiation enabled P&G to claim market share.

As the market is saturated with a proliferation of brands, P&G regarded brand building as vital to differentiate its products. The company spent heavily on advertising to foster among its target consumer groups a desire for using P&G's product lines.

Product innovation and local adaptation

P&G sees innovation as the driver of organic growth. P&G on average introduces one new brand of product in the Chinese market every six months. P&G's approach to innovation is to have a clear differentiation between its customers so that the company is able to ensure that it does not overspend on innovation at the low end and can more accurately meet the needs of the various tiers of consumer in its markets.

P&G adopts an open innovation model called "Connect and Develop" which taps into the creative thinking of not only its own researchers but also the ideas of a wide spectrum of individuals outside the company as well. Based on this model, P&G collaborates with organisations around the world, "systematically searching for proven technologies, packages and products that P&G can improve, scale up, and market", says P&G's Vice-President for innovation and knowledge.

P&G researchers' innovative ideas are not all confined within the walls of its company. Very often, observation starts the researchers on the path of discovery. For example, noticing Chinese women washing laundry and hanging it from apartment window to dry, R&D staff in China came to realise that though many households had washing machines, women were reluctant to use them because of costs of water and electricity involved. To address this market need, P&G created two further version of its top-tier laundry detergent – Tide Triple Action, launched in 2001 and aimed at the middle-tier

low-income consumers, and Tide Clean White to target the bottom tier consumers. Such response to consumer needs helped to boost sales of its detergents.

Supplier/retailer collaboration

P&G endeavours to build superior relationships with external stakeholders to create a favourable external environment, which is supportive of its business goals. P&G sees retailers as its customers and attributes its success partly to its healthy cooperation with retailers.

P&G was the first manufacturing company to set up an Efficient Consumer Response (ECR) system in China. Its firm commitment in the power of this mechanism in smoothing relationship of supply chain related parties had led to the establishment of the ECR China in 2001, with the company as the manufacturer representative convenor and Shanghai Lianhua Supermarket as the retailer representative. P&G's active engagement of industry counterparts in ECR not only had promoted the development of ECR in China, but also enhanced P&G's image in the industry.

P&G embraces information technology as a means to forge closer ties and streamline the supply chain to deliver higher value to customers. For instance, the strategic collaboration between P&G and Lianhua in China has helped to optimise the supply chain and enhance procurement efficiency, thereby achieving enlarged market share, brand influence and competitiveness for both parties. Both P&G and Lianhua believe that information technology is the core technology for optimising the supply chain system and they collaborate closely on data collection, data analysis and information sharing. By adopting a consumer-driven supply and replenishment approach, inventory reduction, higher order satisfaction level, inventory turnover improvement and supply chain efficiency enhancement are achieved. The P&G/Lianhua collaboration illustrates the power of collaboration in value creation.

Key takeaways

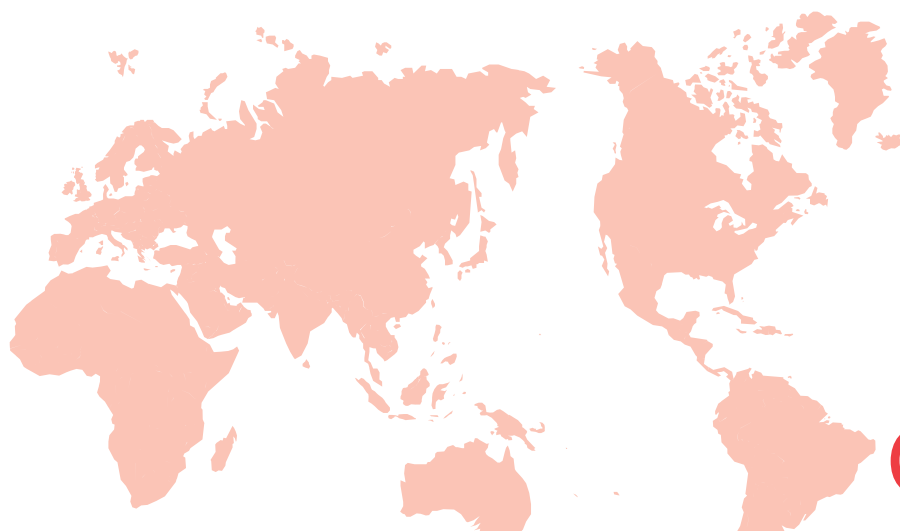
Knowledge of consumer tastes, focused product portfolio and brand-building as well as collaboration with partners in the extended supply chain are important success factors in market entry and sustainability, as illustrated in P&G's case.



China

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India



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

Capital²: New Delhi
(Number of inhabitants: 19.7 million)

Population (million): 1,095
(US 296 – EU25 459 – World 6,000)

Median age: 25 years

Nominal GDP (USD billion): 797.8
(US 12,487 – EU25 13,447 – World 44,183)

Nominal GDP (USD billion at PPP): 3,824.6
(US 12,487 – EU25 12,657 – World 59,763)

GDP per head (USD at PPP): 3,491.7
(US 42,129 – EU25 27,538 – World 9,962)

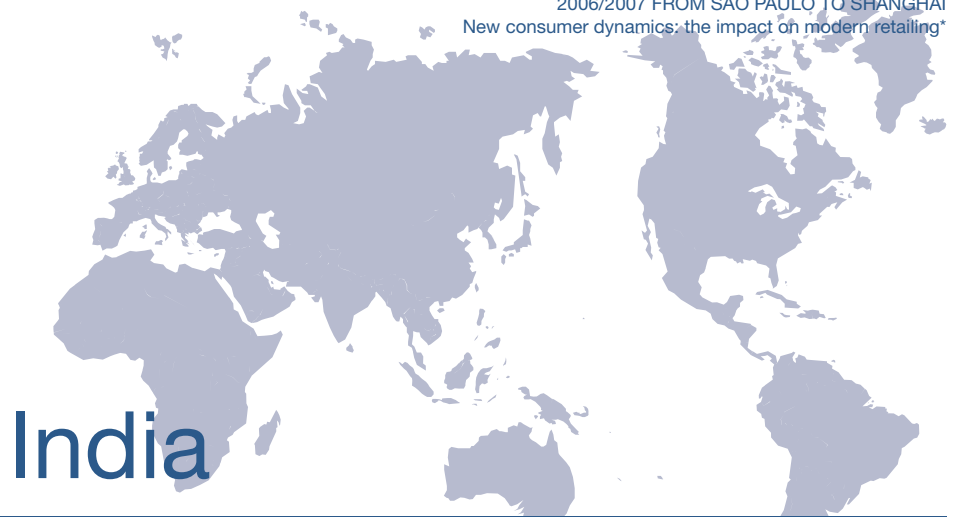
Currency³: Indian Rupee (INR)
(USD1 = INR44.1)

Languages³: Hindi, English and other regional languages

Main religions³: Hindi, Muslim, Christian

Government type³: Federal Republic

Sources: () Economic Intelligence Unit 2006 data,
(¹) World Bank 2005, (²) City Population,
(³) CIA Fact book



India

GDP AND CPI

Services driven GDP growth

Many reforms are underway

Very attractive investment destination

ECONOMIC OVERVIEW

India is currently undergoing an economic revolution which is generating fast-paced changes and development.

Optimistic macroeconomic drivers such as a stable 8% annual growth, rising foreign exchange reserves of close to USD140 billion, consistent and flowing foreign direct investment (FDI) of close to USD8 billion, and an export surge in excess of 20%, all together enabled the Indian economy to expand in 2005. The sustained growth in the services sector has had an especially positive impact on the Indian economy.

Indeed with GDP growth set between 7 and 8% for the third consecutive year, fuelled by strong consumption and productive investments, the Indian economy is in good health. Monetary, budget and external accounting tensions should not be under-estimated but remain under control for now. In order to pursue and amplify this movement, a number of liberalising reforms have been engaged for the Indian market and the improvement of infrastructure.

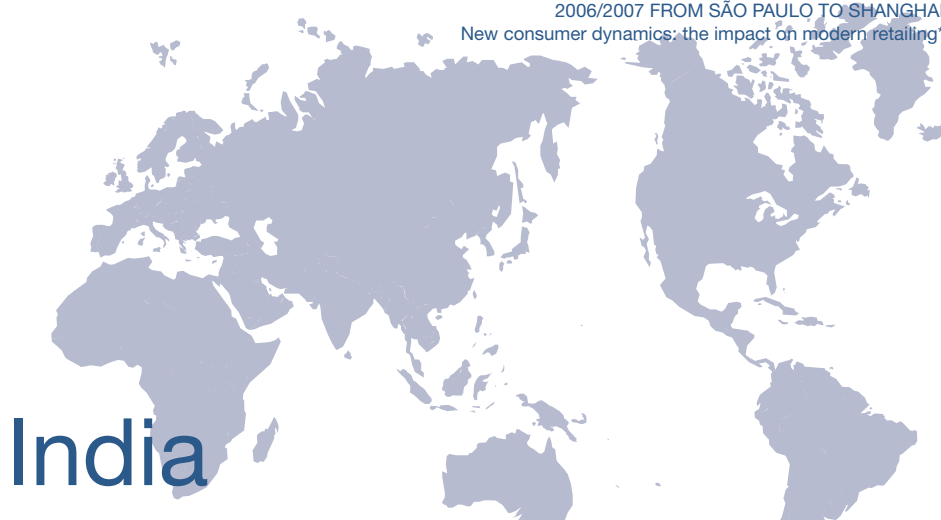
With a rapidly expanding consumer base (private consumption currently accounts for 61% of India's GDP¹) and stabilised consumer price index rate at 4.2%, India is a now preferred investment destination. India has surpassed the US to become the second-most favoured destination for foreign direct investment (FDI) in the world after China².

GDP and CPI

	2002	2003	2004	2005
GDP growth (%)	3.6	8.3	8.5	8.5
CPI (%)	4.3	3.8	3.8	4.2

Source: EIU, July 2006

1 Morgan Stanley, "India and China: News Tigers of Asia, Part II." (June 2006)
2 AT Kearney's FDI Confidence Index



India

UNEMPLOYMENT

Steady decrease in unemployment

Unemployment

	2002	2003	2004	2005
Unemployment rate (%)	10.3	8.3	9.1	8.9

Source: EIU, July 2006

Unemployment has decreased slightly from 9.1% in 2004 to 8.9% in 2005. It is predicted to decrease in the coming years.

ECONOMIC FORECAST

A very positive economic outlook but government action is required

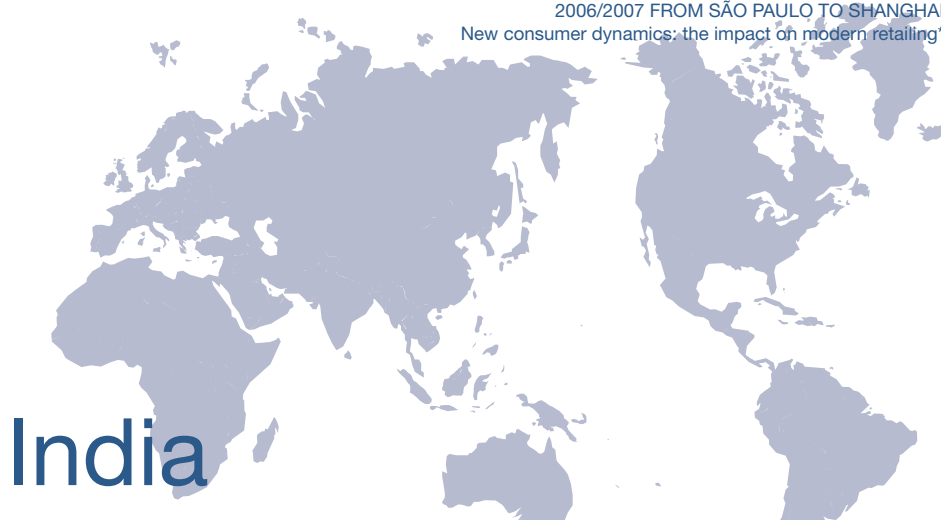
Key economic forecasts

	2006	2007	2008
GDP growth (%)	7.5	7.4	7.0
CPI (%)	4.8	4.1	4.4
Unemployment rate (%)	7.8	7.4	6.9

Source: EIU, July 2006

While India has a high growth future ahead, it will need to deal with key development issues in order to realise its full potential, namely³:

- Address protectionism of certain industries and sectors.
- Mobilise capital more efficiently in order to streamline infrastructure development.
- Continue to establish Special Economic Zones (SEZs) in areas without land title disputes. SEZs could become cities with their own regulatory and bureaucratic infrastructure, which would enable India to accelerate urbanisation and economic development.
- Consider selling state-owned assets in order to kick start a planned USD100 billion infrastructure programme as the motor to India's modernisation.



India

FOREIGN DIRECT INVESTMENT

Foreign direct investment is open to single brand retailers

REGULATORY ENVIRONMENT

Tempered liberalisation of retail industry regulations

Steady increases in FDI

	2002	2003	2004	2005
FDI (INR m)	273,530.2	201,379.6	248,062.4	295,293.4
FDI (USD bn)	5.6	4.3	5.5	6.7

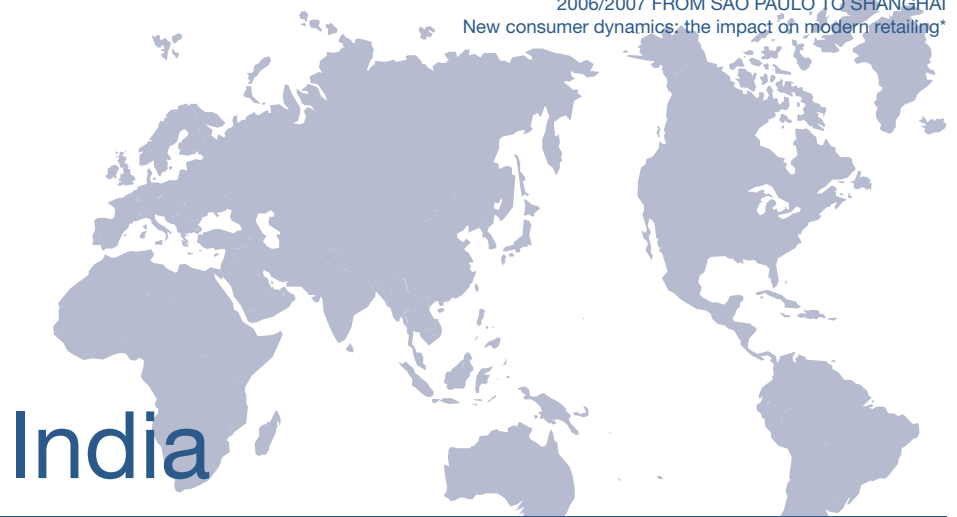
Source: EIU, July 2006

Foreign investment in India is 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 activities without prior Government approvals, except for a few strategic sectors. The FDI policy is framed by the Department of Industrial Policy & Promotion (DIPP), the Ministry of Commerce & Industry and the Government of India. It is implemented by the Reserve Bank of India (RBI) for cases falling under the automatic route (i.e. not requiring prior approval); and the Foreign Investment Promotion Board (FIPB) at the Ministry of Finance, if approval is required.

Prior to 1997, while the FDI policy recommended specific FIPB approval in trading, FIPB also considered and approved, on case-by-case basis, applications for the retail-trading segment.

The current policy of the Government of India prohibits FDI in retail trading except for single brand retail that fulfils the following conditions:

- Maximum 51% foreign equity permitted space.
- Prior FIPB/ DIPP approval required.
- Products to be sold should be of a 'Single Brand' only.
- Products should be sold under the same brand internationally.
- 'Single Brand' product-retailing would cover only products which are branded during manufacturing.
- Any addition to the product/ product categories to be sold under 'Single Brand' would require a fresh approval of the Government.



*Investment in multi-brand
retailing under consideration*

With the opening of single brand retail to FDI, the Government took a major step in opening the retail sector to FDI. This step towards liberalisation is aimed at attracting investment in production and marketing, improving the availability of branded goods for consumers, encouraging increased sourcing of goods from India and enhancing competitiveness of Indian enterprises through access to global designs, technologies and management practices.

The Government is currently deliberating permitting FDI in multi-brand large and medium format retail stores. The primary driver for the proposed change in the FDI policy is to provide an impetus to the agricultural sector and to enable farmers to participate in retailers' plans to move food "from the farm to the plate." The government estimates that between 30 to 40% of the agricultural produce is wasted due to the absence of cold chain facilities. It is hoped that FDI in retail can bring about a revolution in agriculture through value addition, processing and marketing.

FDI in wholesale and export trading has currently been put under the automatic route. The policy does not define wholesale trading but a recent judicial decision suggests the term to include sale to "retailers, industrial, commercial, institutional or other professional business users or to wholesalers and related subordinated services."

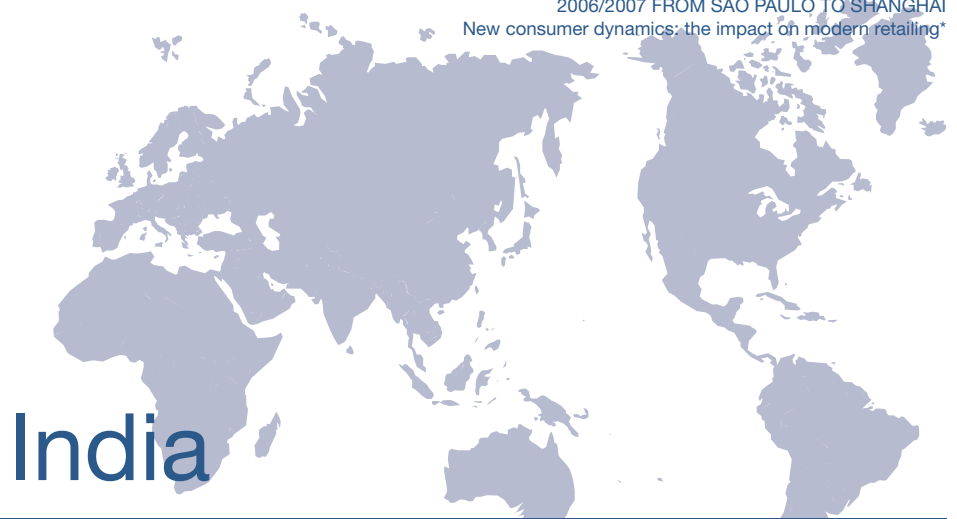
PROPERTY/REAL ESTATE

*Finding retail space is a
challenge*

The current retail boom is impacting the commercial real estate sector. Most of the major Indian cities have significant retail projects under construction. Property prices across the country having seen some rationalisation in the past; but an upsurge in demand is ensuring that prices are peaking.

According to Government policy, up to 100% FDI, is 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, etc.), subject to certain minimum area and capitalisation conditions, being met.

In most cities, it is difficult to find suitable properties in central and downtown locations for large format retail stores, 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. While most of the Indian players have ready and easy access to prime real estate locations, foreign companies have to rely upon shopping malls and rentals for their outlets.



A range of inhibiting property regulations

Other issues that slow-down the growth of the retail industry include:

- Very high stamp duties on transfer of property, varying by state.
- 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. This problem is compounded 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 projects smaller commercial plots and this, along with rigid building and zoning laws, make it difficult to procure retail space.

SALES TAX

A complex regime

Sales tax rates differ from state to state making supply chain management a challenging task for organised retailers. Inter State sale attracts Central Sales Tax while for some categories of products, certain states levy import or entry tax on entry of goods into their territory. Simultaneously, a few States levy exit taxes when the goods are moved for sale outside the territorial barrier of the respective States. Sales tax evasion by small retailers in order to offer lower prices/ fetch higher margins is also a practice prevalent in the local markets. Other than state taxes, local bodies (e.g. municipal corporations, etc.) also levy octroi in some locations.

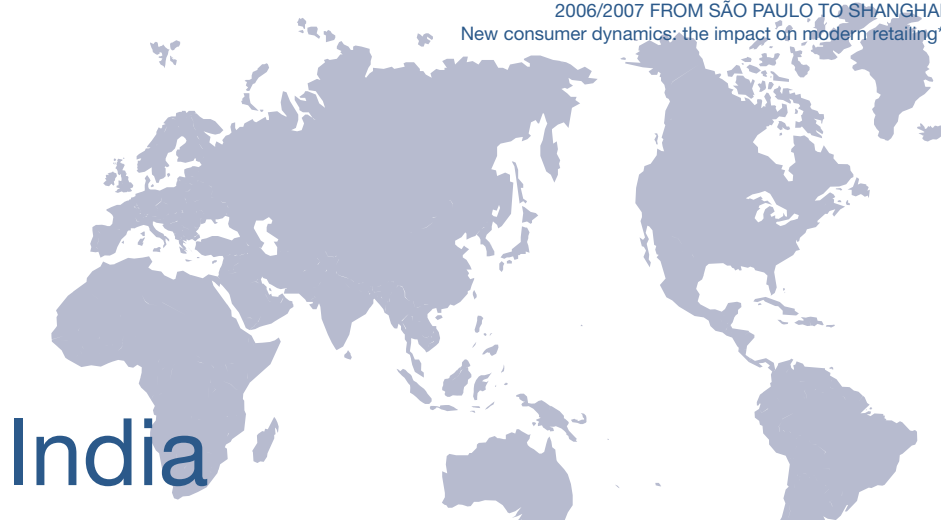
VALUE-ADDED TAX

Ranging between 4 and 12.5%

In order to streamline the domestic commercial taxation system the government introduced Value Added Tax (VAT) as of April 1, 2005. Rates applicable are 4% for most essential goods and 12.5 % for all other items. Besides this, there is a Central Sales Tax (CST) of 4% in respect of inter-state sale which is not available for set-off against final destination-based VAT. Presently, all states except Tamil Nadu and Uttar Pradesh, have implemented VAT. Tamil Nadu and Uttar Pradesh will continue to be governed by the sales tax laws until they switch over to VAT.

In order to harmonise the tax structure, it is proposed that India should move towards a national level Goods and Services Tax (GST) and has proposed to set April 1, 2010 as the date for introducing GST.

VAT has a strong bearing on the retail and consumer sector. Previously, most retail traders are not liable to pay tax, since the tax is being paid by the first seller. Consequently, the retailers who enacted last point sales to consumers were outside the tax net. Under the VAT regime, tax is levied on value addition



India

CUSTOMS CODE

Changing customs barriers

at each stage of sale, thus, covering all retailers. However, small retailers will be kept out of VAT and only retail traders having annual turnover exceeding a specified limit are required to obtain registration under VAT. Retailers having turnover exceeding the specified limit have the option to pay composition tax or come under VAT. Retail traders already registered under the sales tax regime shall automatically be registered under VAT.

In order to implement VAT successfully, the Government should further develop the organised retail sector in India. In addition, retailers' margins will not be adversely affected as no additional costs are being imposed. The increases in prices, caused by the tax increases, are typically recovered from customers. It is also expected that in the medium term, prices of goods will stabilise and in the longer term, business will grow in overall terms. Over time therefore, the VAT will be good for business.

Customs or import duties are levied by the Central Government of India on goods imported into India, based on the nomenclature prescribed for such goods. Duty is levied on the transaction value of the imported goods at the rate specified in the Customs Tariff Act, 1975. The general principles adopted for valuation of the goods under the Customs Act are in conformity with the WTO agreement on customs valuation.

The Central Government reduced the peak rate of basic customs duty chargeable on goods imported into India to 12.5% (for non-agricultural and other specified goods). In some cases, certain goods are fully or partially exempted from levy of customs duty. Most consumer goods generally attract a peak rate of basic duty 12.5%. An additional customs duty equivalent to the excise duty on like-goods manufactured in India is also levied on imports. This is typically levied on the maximum retail price less abatements which have been printed for such goods.

All imports as of March 1, 2006 are also chargeable to an additional duty of customs at 4% instead of sales tax/VAT with few exceptions.

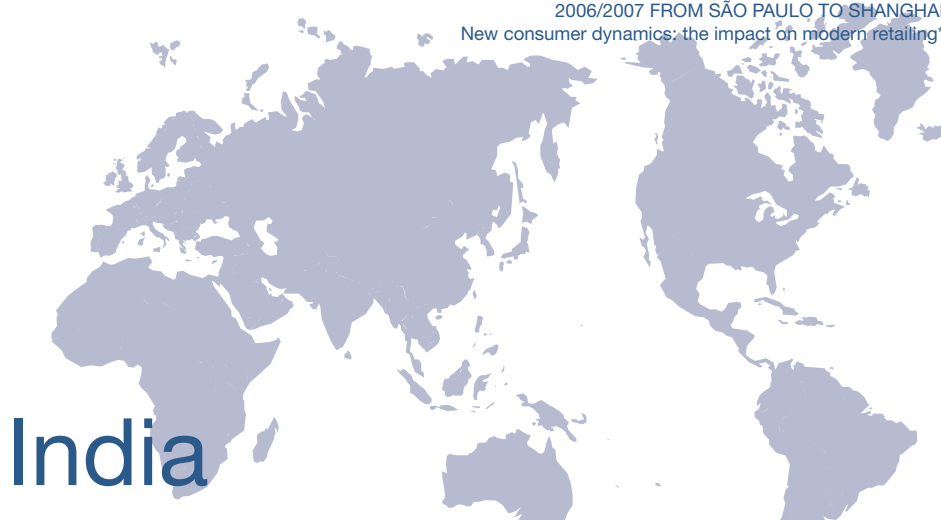
An Education Tax (EC) at 2% is also levied on the aggregate of duties of customs (except safeguard duty, countervailing duty and antidumping duty). Goods attracting customs duties at bound rates under international commitments (for example, IT Agreement, Indo-US Textile Agreement) have been exempted from this cess.



India

India, as a founding member of the World Trade Organization (WTO), has agreed to bind its Customs Tariff 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 (QRs) in accordance with the commitments made to the WTO.

Recent reductions in various customs duty rates below the bound rates indicate the continued efforts of the Government of India to rationalise and align duty rates in accordance with the rates prevailing in the South-East Asian countries. With the implementation of WTO norms and further removal of restrictions from the import regime, the retail sector outlook appears bright.



India

POPULATION EVOLUTION

A large and growing workforce

POPULATION BY AGE GROUP

A young and consumerist population

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

A growing population, a youthful workforce and soaring consumer confidence are solid arguments for long-term growth.

India's population in 2005 is estimated to be 1,095 million. By 2016, India will have the second highest urban population in the world after China.

Population

	2002	2003	2004	2005
Population (m)	1,049.7	1,065.1	1,080.3	1,095.3

Source: EIU, July 2006

More than 50% of India's population is less than 25 years of age, compared to other developed countries, where the majority of the population is ageing baby boomers.

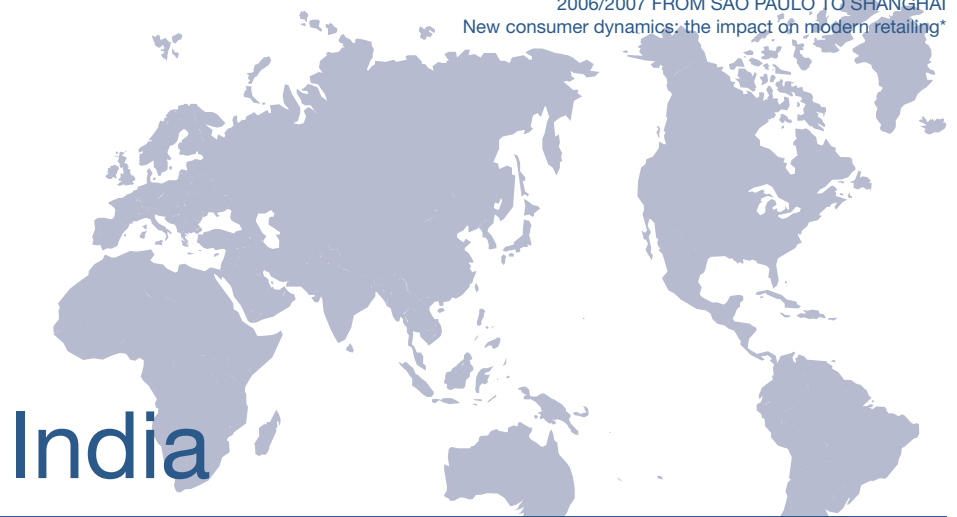
Age profile

% of total population	1999	2004	2009(f)	Trend
0 – 14 years	34.0	31.7	29.6	↓
15 – 64 years	61.4	63.5	65.2	↑
Over 65 years	4.6	4.8	5.2	↑

Source: EIU, July 2006

The consumerist age-bracket (ages of between 15 to 64 years) as a proportion of the Indian population is growing rapidly and will represent more than 65% of the population in 2009. In other words, the ratio of working population to non-working population, defined as the dependency ratio, will increase in the near future.

This will increase the overall purchasing capacity in the country, providing further buoyancy to the retail sector. Members of the consumerist age-bracket are the most likely to prefer and adapt to modern retailing, assuming that they generate adequate incomes and reside in urban areas.



URBANISATION OF THE POPULATION

Widening urban/rural gap

The urban population in India is expected to grow at a compounded annual growth rate (CAGR) of 2.4% from 2000 to 2015, representing an increase from 28 to 32% of the total population.

Urban/Rural split

% of total population	1999	2004	2009(f)
Urban	27.4	28.5	30
Rural	72.6	71.5	70

Source: EIU, July 2006

As a consequence of urbanisation, more and more households are emerging with increased purchasing power and a heightened desire to spend their income. Studies in developing countries suggest that, on average, urban households spend 2.5 times more than rural families. Thus, the target market for many organised retail players is the urban population.

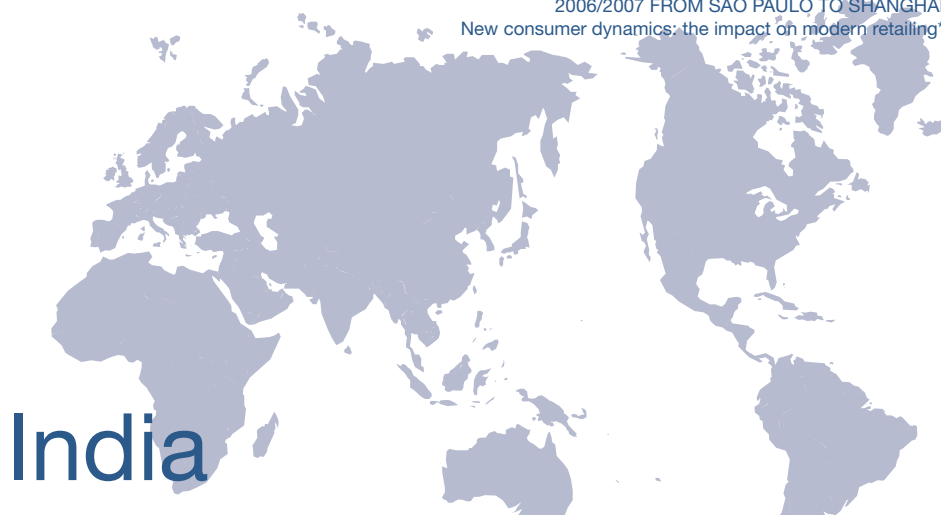
Currently, organised retailing is focused in metropolitan cities and is expected to extend to Tier II cities. The top six Indian cities — Mumbai, Delhi, Chennai, Kolkata, Bangalore and Hyderabad — represent 6% of the population and contribute 14% to India's GDP. These cities account for 68% of organised retail and the by end of 2006, over 60% of shopping malls will be located in these cities. For the next 10 years, growth in organised retailing is expected to occur in urban centres.

INCOME/BUYING POWER

Greater disposable incomes

Rapid economic growth has resulted in greater incomes for the booming Indian middle class. Disposable incomes are expected to increase at an average of 8.5% per annum till 2015. Per capita income in India has been steadily rising from USD460 in 2002 to USD620 in 2005.

Higher numbers of working women have also increased both consumption and purchasing power; the population of working women has increased from 22% in 1991 to 26% in 2001.



India

Income, Expenditure and Savings (USD billion)

	2001-2002	2002-2003	2003-2004	2004-2005
Personal Disposable Income	437	459	514	563
Real Personal Disposable Income Change p.a. %	7.1	5.0	11.8	9.5
Private Final Consumption Expenditure	331	342	382	420
Household Sector Savings	112	126	144	153

Source: Reserve Bank of India

Household earnings

% of households earnings per annum	1995	2000	2005	2010
> USD 1,000	69.8	76.6	94.4	100.0
> USD 3,000	7.4	9.6	22.8	53.8
> USD 5,000	2.0	2.6	6.4	19.2
> USD 10,000	0.3	0.4	1.1	3.3

Source: EIU, July 2006

CONSUMER BEHAVIOUR

Rapidly changing, more demanding consumers

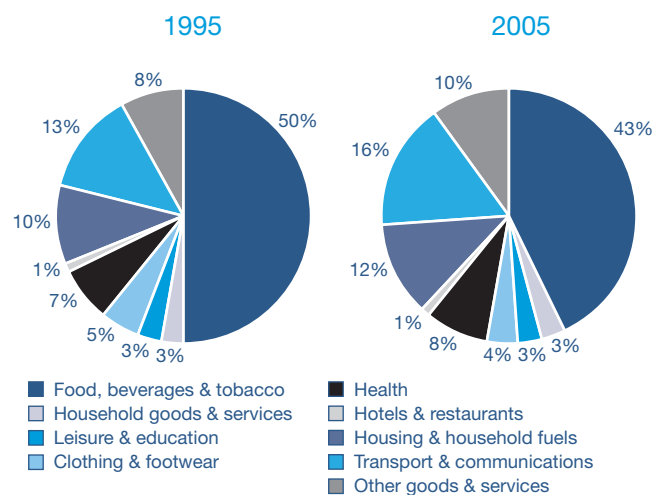
With increasing disposable incomes and the highest ever consumer confidence levels, Indian consumers' ability and desire to spend is growing rapidly. Total private final consumption in India amounted to USD420 billion in 2005 compared to USD382 billion in 2003. It has been growing at almost 10% annually over the last few years.

Food, beverages and tobacco are the largest single component of private final consumption (around 40%). Its share has been steadily declining from 48% in 2000 to 43% in 2005, mainly due to changes in consumers' spending preferences towards more non-essential, lifestyle-oriented purchases.



India

Composition of average household expenditure: 1999 vs 2005



Source: EIU, July 2006

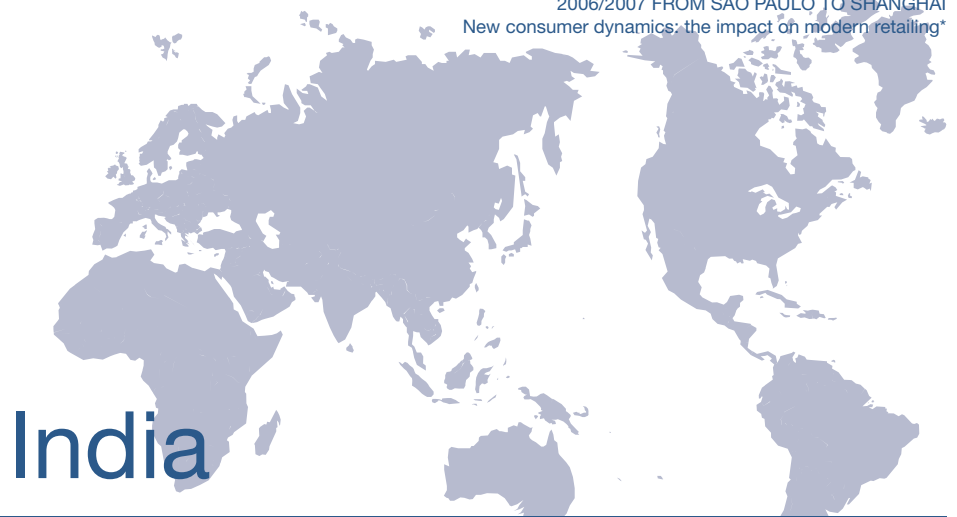
Lifestyles/Shopping habits

More leisure and luxury-oriented shopping habits

Indian consumers' lifestyles and shopping habits are rapidly evolving. Discretionary spending witnessed a 16% increase for the urban upper and middle classes. Lifestyle habits are shifting from austerity to complete self-indulgence and Indians are now unapologetic about spending lavishly on non-essential goods such as luxury watches, cars, hi-tech products etc.

There is an easier acceptance of luxury and an increased willingness to experiment with mainstream fashion. Expenditure on personal care items and clothing has increased since there is greater emphasis on "looking and feeling good". Similarly with new shopping malls offering multiplexes, restaurants and bars, video game centres, etc in both large and smaller cities, shopping has evolved from a need-based activity to a leisure pastime. Therefore, expenses on activities, such as watching movies and eating out, have increased considerably.

With the growth of middle class families, home textiles and electronics/ consumer durables are increasingly becoming a means to demonstrate prosperity while at the same time creating a comfortable home environment. Finally, credit friendliness, drop in interest rates and easy availability of finance have changed mindsets of this segment. Capital expenditure such as jewellery, houses and cars is shifting to becoming redefined as consumer revenue expenditure. The number of credit cards issued has grown at a CAGR of 26% in the last 5 years to touch 15.5 million by March 2005.



Price/Brand sensitivity
*Stronger brand
consciousness*

Indian consumers' purchasing habits and preferences are evolving towards a strong predilection for brands. Consumers equate brands with an intangible value for which they are willing to pay premium prices. There is a high degree of differential pricing structures between branded and unbranded goods in India.

There are also differences between urban and rural consumers. Rural consumers are economically, socially and psychologically different from their urban counterparts and are definitely more price-sensitive. To address this issue, most FMCG companies have introduced products (such as tea, shampoos, biscuits) in smaller packs and sachets to make the product more affordable for rural consumers and obtain a share of wallet.



India

RETAIL AND CONSUMER SECTOR PERFORMANCE

Strong growth perspectives in consumer goods are further reinforcing the potential of the retail sector in India.

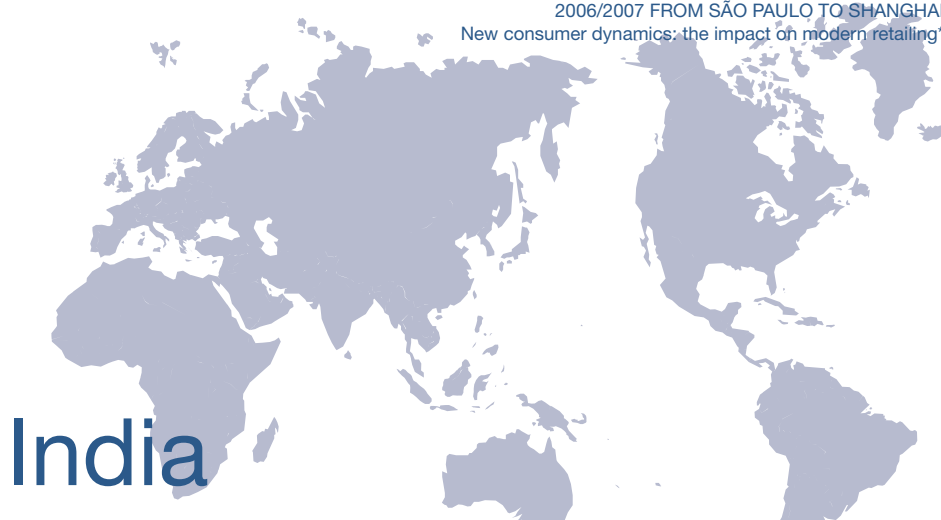
MAJOR CONSUMER GOODS PLAYERS

The FMCG market is set to treble

The consumer goods market should grow from USD11.6 billion in 2003 to USD33.4 billion by 2015. Penetration levels and per capita consumption in most product categories like jam, toothpaste, skin care, hair wash, etc. suggest that market potential is yet to be leveraged.

Since 2003, consumer goods firms have been struggling with cost issues, competition from domestic and foreign companies and a declining share of wallet from consumers preferring to purchase durables, luxury goods and automobiles. However, the sector is currently experiencing an upswing; in February 2006, the FMCG sector registered a 10.6% growth (year-on-year) in sales, representing the highest rate of growth since 2001. Increasing growth, estimated to be between 3 to 4%, is attributed to higher rural demand, enhanced retail sales and a healthy economy. Growth occurred across all major categories (except for packaged tea).

Industry watchers estimate that the average growth in rural and semi-urban markets has been twice that of the total industry growth of 12 to 15% over 2005-2006. As such, the FMCG sector is projected to grow at a compounded rate of 10% by 2012. More than 50% of growth is expected to derive from rural and semi-urban segments. Analysts estimate that FMCG penetration in rural markets is quite low and products such as soaps, detergents, cold drinks, consumer durables, toothpastes, batteries, biscuits, salted snacks, mosquito repellents, etc will fuel growth in rural markets.



India

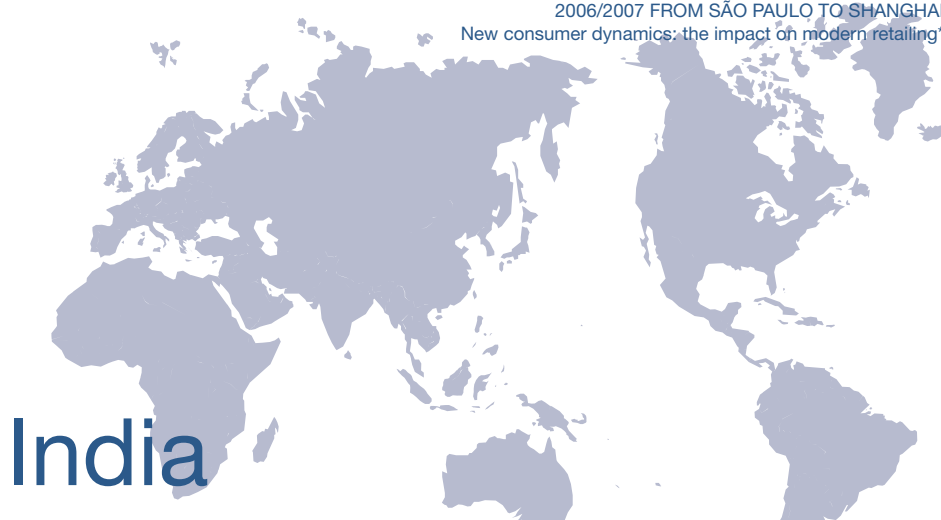
Major consumer goods players

Company	Product Offerings	2005 sales (USD m)
ITC Limited	Cigarettes, Food, Stationery, Safety Matches, Incense, Hotels, Agri Business	3,018
Hindustan Lever Limited	Home and Personal Care, Food & Beverages	2,658
Nestlé India	Food & Beverages	587
Nirma Limited	Consumer and Industrial	477
Brittania India Limited	Dairy and Bakery	358
Dabur India Limited	Health and Personal Care, Food Products	305
Glaxo Smithkline Consumer Healthcare Limited	Health Food and Drinks	242
Colgate-Palmolive India	Oral, Personal and Household Care	238
Marico	Beauty and Wellness, Hair Care, Skin Care, Healthy Foods	212
Procter & Gamble Hygiene and Health Care Limited	Health and Feminine Care	165

Source: Capitaline

Food and beverages Government spurred growth

The Indian F&B sector is showing indications of revival, after a period of sluggish growth for four years, and is yielding returns of 50 per cent in 2005. Government initiatives are also spurring the growth of the F&B market. The Indian Railway Catering and Tourism Corporation (IRCTC), an autonomous body under the Railway Ministry, created a plan to open 2,000 stalls which would serve food to travelers. The Railway Ministry is planning to invite F&B companies to open stalls across India.



India

MAJOR RETAIL PLAYERS

A high potential industry necessarily dominated by domestic players

Comprised of organised and traditional retail formats, India's retail market is estimated to be worth USD350 billion:

- Organised retail is estimated at USD8 billion. Organised retail is growing at over 30% annually.
- Of India's 12 million retail outlets, more than 80% are operated by small family businesses using household labour.

The retail industry represents 13% of GDP and accounts for 6% of India's workforce. Burgeoning growth rates in the retail industry are attributed to:

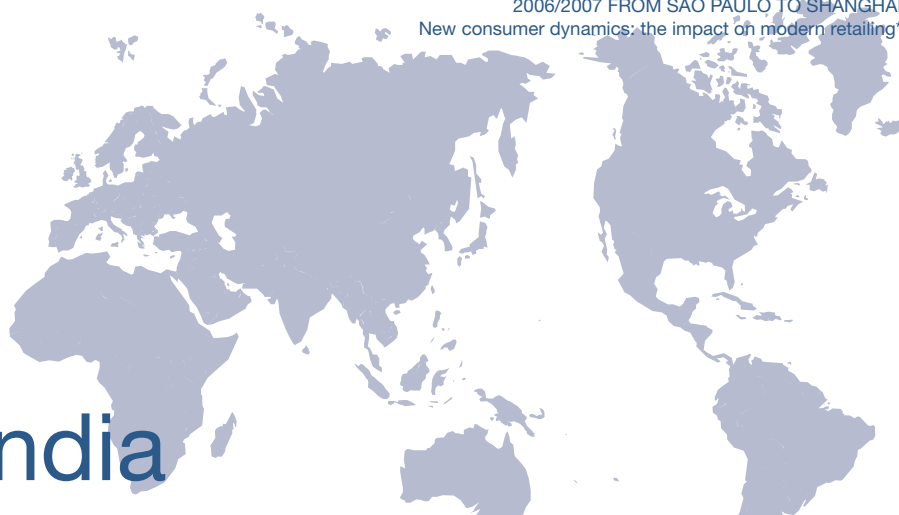
- Growth in India's economy
- Changing consumption and expenditure patterns
- Rising incomes

Top 5 major retail players

Retailer	Existing formats	Brand name	Number of stores	Total retail space ('000 sq ft)	Total sales 2004-05 (USD mn)	Expansion Plans
Pantaloon Retail India Ltd.	Department Stores	Pantaloon	13	1,948	241	Invest around USD125 mn between FY06-FY08. Open 80-100 more stores across formats
	Hypermarkets	Big Bazaar	18	N/A	N/A	Triple total retail area by FY08 to 6.5 mn sq ft
	Supermarkets	Food Bazaar	9	N/A	N/A	Enter into furniture and home retailing
	Seamless Malls	Central	3	N/A	N/A	
RPG Retail	Hypermarkets	Spencer's	3	480	96	Open 21 hypermarkets and supermarkets in next one year
	Music Stores	Music World	225	N/A	N/A	Open another 100 MusicWorld stores by FY08
	Supermarkets	Spencer's	49	N/A	N/A	May go for an IPO next year to raise capital



India



Shopper's Stop Ltd.	Department Stores	Shopper's Stop	20	1,000	96	Add 2 mn sq ft of retail space FY08
	Books & Music Stores	Crosswords	33	N/A	N/A	Entering hypermarket format, 18 stores planned by FY08
	Home Furnishings	Home Stop	N/A	N/A	N/A	Setting up speciality stores for Home Solutions
Landmark Group (based in Dubai)	Department Stores	LifeStyle	8	370	67	Set up 25 new departmental stores by FY08 Invest USD65 million over the next 5 years
						Enter into Hypermarkets, home improvement and fast fashion
Trent India Ltd.	Department Stores	Westside	19	350	52	Add 640,000 sq ft of retail space
	Hypermarkets	Star India Bazaar	1	N/A	N/A	Open 17 stores under the departmental and hypermarket format by FY08
	Books & Music Stores	Landmark	4	N/A	N/A	

Industry estimates suggest that USD412 billion will be invested in the retail sector by 2011. The majority of this investment will be directed towards the two most popular retail formats: hypermarkets and supermarkets. According to product category, half of the investment could be directed to food-related retail and the remaining share would be allocated to non-food retail.

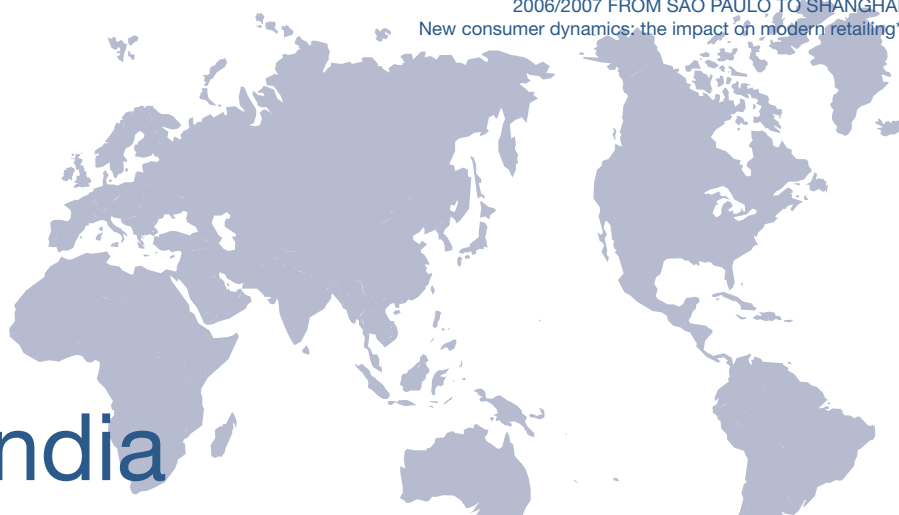
Food retail channels

An industry in transition

Although independently-owned local grocery stores are still the most prevalent format, larger supermarkets and convenience chains are emerging in organised food retailing. Organised food retailing in India is worth USD666 million and will increase to USD33,333 million by 2015. The sector is estimated to grow at 30% annually.



India



Hypermarkets

Drivers for growth

Hypermarkets offer several product categories including fresh foods often sold in bulk, typically stocking 60% food and 40% non-food items. Hypermarkets are expected to fuel retail growth since food and grocery stores account for 76% of consumer expenditure.

Supermarkets

Preferred for their location

Supermarkets are frequented by consumers who prefer convenience, quality and hygienic surroundings. Pantaloon Retail (Food Bazaar) is the largest supermarket operator in India in terms of market value.

Convenience stores

Attached to the petroleum industry

Convenience stores are typically located near petrol pumps and serve motorists. State-owned Bharat Petroleum Corporation Limited plans to add 10 "In & Out" convenience stores in New Delhi by the end of the 2006 to 2007 as part of its retail outlet expansion plan.

Discount stores

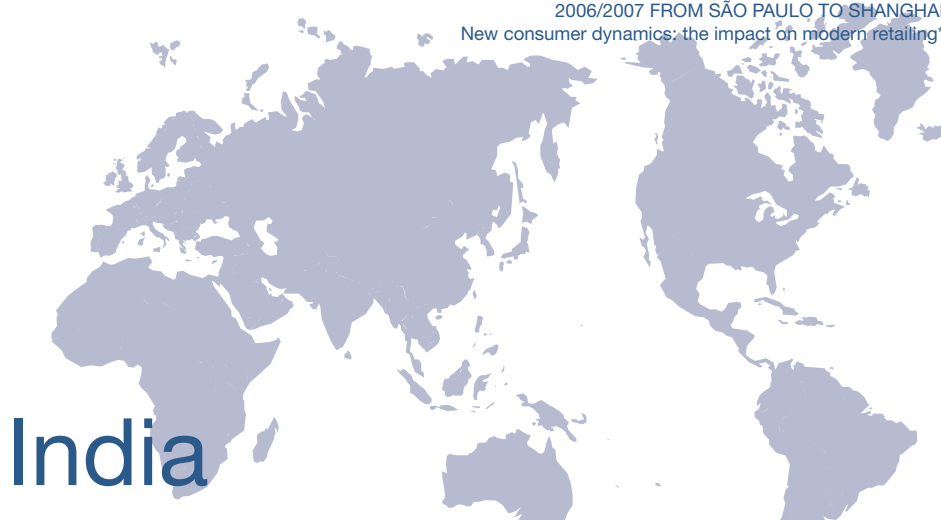
A nascent format

An emerging retail concept is discount stores providing 8-10% on Maximum Retail Price (MRP). Chennai-based Subiksha is the largest discount store operator at present.

Food and Grocery—2005-2006

Retail Format	Group name	Store brands	Number of stores	2005 net sales (USD m)
Hypermarkets	Pantaloon Retail	Big Bazaar	27	249
	Tata Trent	Star India Bazaar	1	55 (FY 2004-2005)
	RPG	Spencers (Giant)	N/A	N/A
Supermarkets	Nilgiris	Nilgiris	32	N/A
	RPG & DFI	Foodworld	92	89
	Apna Bazaar	Apna Bazaar	80	31
	The Piramal Group	TruMart Daily	9	N/A
	Home Stores India Limited	Sabka Bazaar	27	
	Trinethra Super Retail	Trinethra	50	
	Pantaloon Retail	Food Bazaar	38	
Discount Stores	Viswapriya	Subiksha	160	64
Convenience Stores	Bharat Petroleum Company	In & Out	580	N/A
Cash and Carry	METRO Cash & Carry	METRO	2	72

Sources: Industry



Rural retail formats

A new and emerging segment

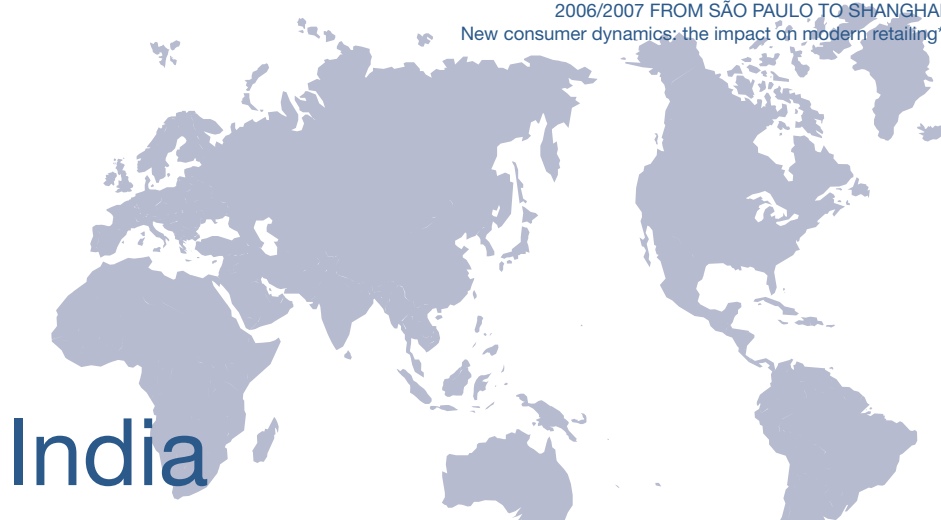
Estimated to be worth USD28.6 billion, India's rural retail market is an attractive market for retailers. With 70% of India's population (700 million people) residing in rural areas, retailers are beginning to aggressively target this segment. In order to cater to the needs of the rural market, companies such as Godrej and DCM Shriram Consolidated are launching "one stop shops" for farmers and their communities.

Traditionally, rural families relied on self-produced grain, vegetables and milk to meet their dietary needs. However, as an emerging trend, rural families are spending larger amounts of their incomes towards purchasing food items. For example, the average family of six in an Indian village is spending Rs.1,800 each month, or one-third of its income to purchase daily food items such as processed and semi-processed foods like milk, milk products, beverages, eggs, meat, fish, cooking oil, spices, sugar, salt, fruits and vegetables.

Perhaps the most stunning finding is that, as a proportion of income, rural families match urban consumers in spending patterns. For example, both rural and urban families spend eight percent of their monthly bill on vegetables. In absolute terms, overall rural spend on non-cereal food items is Rs.55 less than for urban families.

Mini case examples of how some Indian companies are setting up "one stop shops" for rural communities are provided below:

Godrej Aadhaar	TATA Agrico	DCM Shriram Consolidated Limited
<p>This rural retail unit of Godrej Agrovet Limited, provides end-to-end solutions for the agricultural sector.</p> <p>Aadhaar embarked upon social initiatives that target rural India (screening movies, holding kite flying competitions, staging dance performances) as an innovative means to make further inroads with farmers.</p> <p>Aadhaar is planning to set up more than 1,000 stores across rural India by 2010.</p>	<p>In April 2006, Tata Agrico, the agricultural unit of Tata Steel Limited, partnered with Godrej Agrovet to sell agricultural tools. The goal of this venture was to enable farmers to access and learn how to use Tata Agrico's agricultural implements at reasonable prices.</p> <p>Tata Agrico's tools will be sold through Godrej Agrovet's 22 Aadhaar outlets.</p>	<p>The company plans to set up 35 rural/semi-urban utility marts over 2006 - 2007. Positioned as a one-stop shop, this "Hariyali Kisaan Bazaar Chain" will cater to a variety of farmers' needs by providing access to:</p> <ul style="list-style-type: none"> • Petrol pumps • Access to retail banking • LPG outlets • Motorcycle showroom <p>Outlets will span between two to three acres and will cost approximately \$444,000 each.</p>



India

Speciality retail
Specialty Retail is a booming segment

Specialty retailers are offering niche products in alternative medicine, books, clothing and apparel, home furnishings, music, jewellery, alcohol and wine, watches.

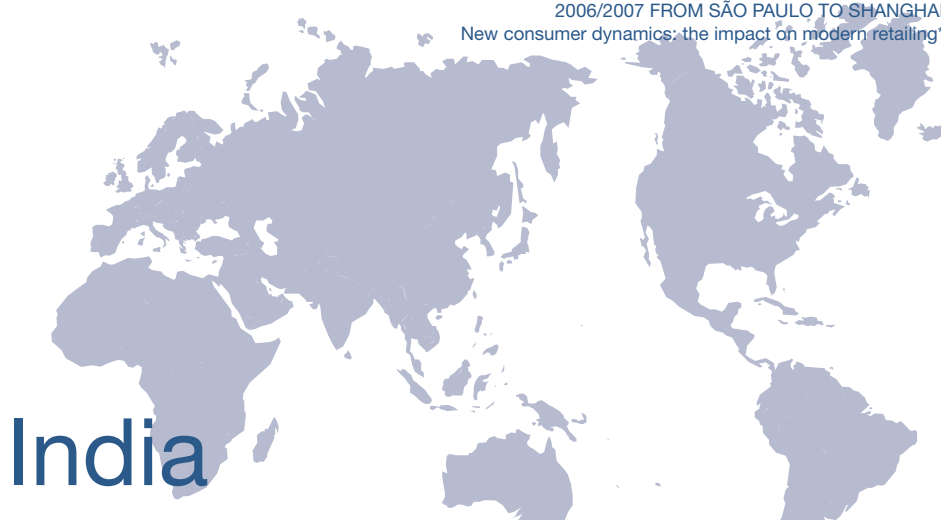
Speciality stores – 2005 - 2006

Specialty format	Group name	Store brands	Number of stores	2005 net sales (USD m)
Home Equipment (electrical goods, furniture)	Godrej & Boyce Retail Division	Godrej	35	N/A
	Home Stores India Limited	The Home Store	14	N/A
	Vivek Group	Vivek's	20	23
Books, Music, Jewellery, etc	RPG	Music World (music)	235	N/A
	RPG	Health & Glow (personal care)	35	N/A
	Bennett Coleman & Co. Limited	Planet M (music)	123	18
	Rosy Blue Group	Orra (jewellery)	30	N/A
	Tata	Tanishq (watches)	83	144 (year ended March 31, 2005)
	K Raheja	Crossword (books)	31	N/A

Sources: Industry

Clothing
Estimated to be worth USD15 billion

The premium or branded apparel market in India is estimated at about USD422 million and growing by 20% annually. The purchase of apparel, alongside jewellery and eating out, constitutes 45% of credit card expenditure. International single-brand retailers such as Guess, Esprit, Mango and Tommy Hilfiger have established a retail presence in this attractive retail market, while others like Next, Debenhams, Giordano, etc. are looking to enter the market following its liberalisation.



India

Watches

Very popular segment

Although the watch segment is the highest penetrated category in organised retail, the USD622 million industry is largely concentrated in unorganised retail and the grey market (60% share)⁴. The fashion watch market is growing by 20 to 25% annually in India with demand stemming from IT Business Process Outsourcing (BPO) professionals in metropolitan cities. Industry sources estimate that 28 million watches are sold annually, with an annual growth rate of 30%⁵. India is emerging as an important market and companies like Swatch Group, Titan Industries Limited, Citizen, Rado and Omega have major expansion plans for India.

Department stores and malls

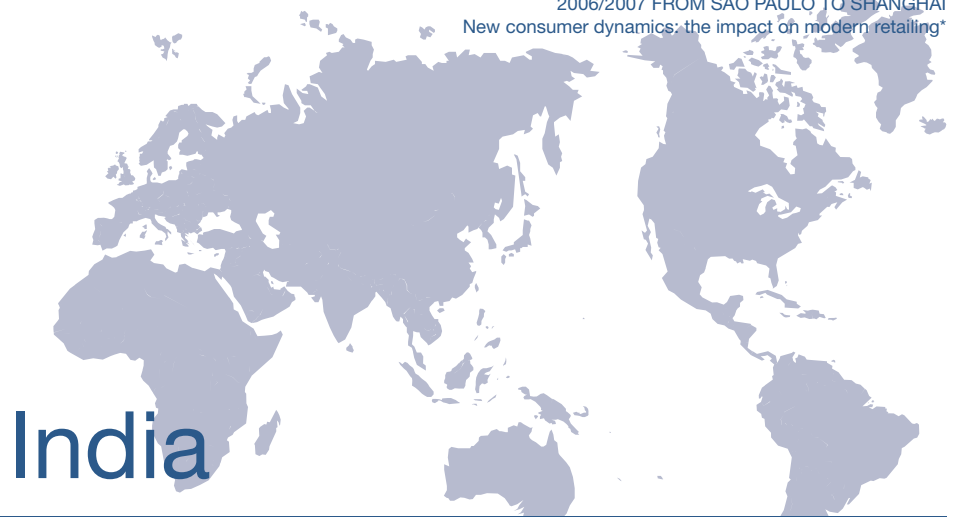
A premium modern retail format

Department stores typically cover between 3,000 and 5,000 square metres and offer several brands and product categories. They are often located in metros and mega-metros, although now retailers are expanding operations into smaller towns⁶. Leading department stores are below:

Key Department Stores	Promoter group	Number of stores	2005 net sales (USD m)	Future plans
Shoppers Stop	K Raheja Group	20	96	Plans to open 19 stores by end 2008
Westside	Trent Limited	19	31	Plans to add 12 department stores by FY08
Lifestyle	Landmark Group	8	76	Will add 27 department stores and 8 home centres by FY 09
Globus	R Rahej Group-Real Estate	12	N/A	Plans to add 13 new stores by end 2006
Pantaloon	Pantaloon Retail	13	47	Plans to have a total of 20 stores by FY09

Sources: Industry, Fitch

4 SSKI India
5,6 IMAGES KSA Technopak. "India Retail Report: 2005."



Shopping malls

The clear way forward

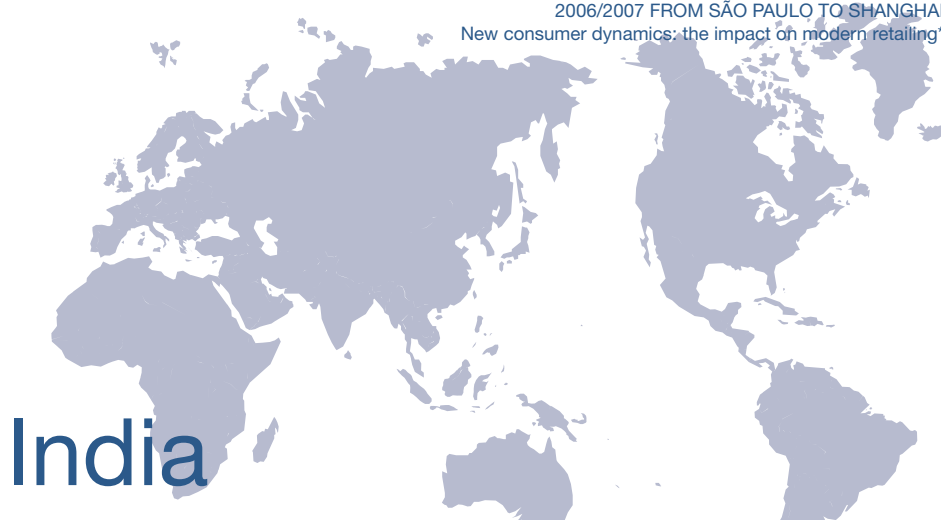
With less than 30 operational malls in 2003, India is expected to have approximately 220 malls by 2007, out of which 125 will be in the six metropolitan cities. Out of the approximately 70 million square feet of retail space under development in India, 41 million square feet are in Mumbai, Delhi, Hyderabad, Chennai, Bangalore, Ahmedabad and Pune. An emerging trend in India is specialty malls, including the Gold Souk, the Auto Mall and The Homeland.

Upcoming malls in India (till 2007)	
Metropolitan cities	No. of malls
National Capital Region	60
Mumbai	28
Hyderabad	15
Bangalore	9
Kolkata	9
Chennai	4
Subtotal	125
Mini Metropolitan cities	No. of malls
Pune	9
Ahmedabad	5
Tier II Cities	81
Total	220

Luxury retail

Very high potential with newly prosperous consumers

The number of foreign luxury retailers had begun to swell even before the Government allowed 51% FDI in joint ventures for chains selling single brands. Others waiting to enter India include Gucci and Giorgio Armani, which will open four stores in Mumbai and New Delhi by 2008. India's first Versace boutique opened in an upmarket Mumbai mall next to an opulent Swarovski store. The Italian luxury brand, which plans to expand quickly in China and India, is the latest to enter India on the heels of other luxury retailers including HUGO BOSS, Burberry, Cartier, CHANEL, Louis Vuitton and Tommy Hilfiger. Though traditionally the Indian consumer has always been perceived as a price-conscious one, the mindsets of consumers and retailers are slowly evolving.



India

Over the past few years, the twin attributes of design and quality have come to acquire increasing significance for the consumer. An estimated 1.5 million households constitute the 'rich consumer' segment (annual income above USD22,990) in the country. Growing by around 20% every year, this segments' buying behaviour is in line with its international counterparts. The market for luxury goods in India, estimated at USD450 million, is booming with international brands now present across categories of higher-end automobiles, entertainment electronics, men's clothing, women's jewellery, women's accessories, including handbags and footwear, watches, gourmet food and wines, as illustrated below:

Categories	Luxury Brands Present
Apparel	HUGO BOSS, Burberry, Aigner
Handbags, footwear	Louis Vuitton, Bulgari, Nine West, Salvatore Ferragamo
Watches	Cartier, Boucheron, Mont Blanc, Omega, Breguet, Baume & Mercier
High-end Cars	Porsche, Mercedes Benz, BMW, Lexus, Audi

E-COMMERCE

A nascent retail format

Indian retailers are beginning to employ Internet shopping initiatives as part of aggressive expansion strategies. With 50 million internet users and as the fourth-largest online nation after the United States, China and Japan, India is an attractive online retailing destination. Approximately 7% of India's online users shop online and when they do, they are usually purchasing travel services, books, electronic items, or conduct online banking. Sources estimate that the total Internet business in India is worth over INR22 billion (USD488.8 million). Major retailers, including Pantaloon, Shoppers' Stop and Globus want to harness the potential of online retailing by establishing e-retailing portals.

M&A ACTIVITY

An impressively busy year

The year 2005 to 2006 was a record year for Indian corporate finance activity with 625 deals valued at INR734 billion (USD16.3 billion), compared with 353 deals amounting to INR234 billion (USD5.2 billion) in the previous year, representing a growth of over 200%. Global private equity players such as 3i, Blackstone Group and Carlyle announced plans to invest in India. Among various sectors, Telecom and IT continued to generate the most deal activity with 34% and 11% of the total M&A deal value respectively. Indian companies are also embarking upon major foreign acquisitions. 2005 witnessed 100 such transactions worth USD2.4 billion, representing growth of 39% over the previous year.



India

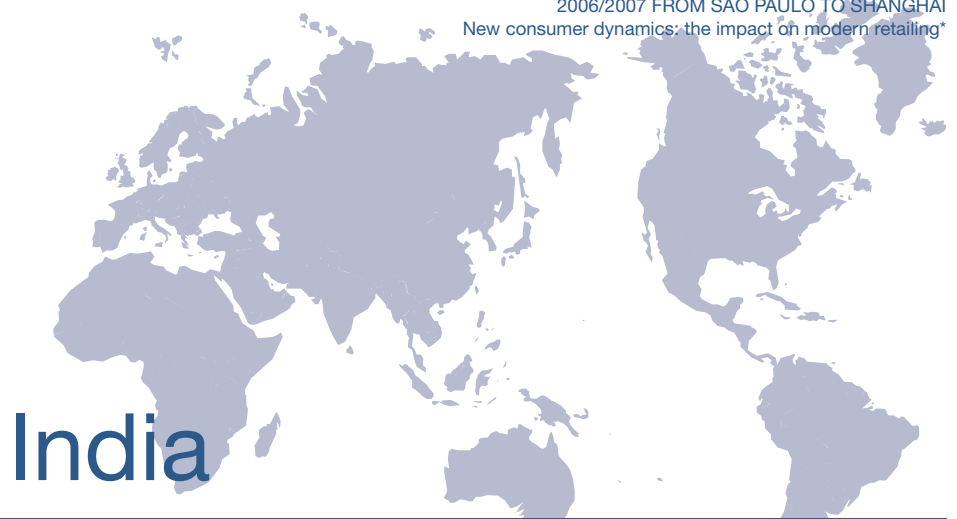
International acquisitions by Indian consumer goods players

Since 2005, the FMCG sector has been experiencing an increase in M&A activity, with the food segment accounting for 5% of the total M&A deal value. As the domestic market is beginning to mature, FMCG players are looking to enter international markets and have chosen acquisition as the preferred route:

Select Retail & Consumer Deals

Year	Acquiree/JV Company/ Target	Acquirer	Nature of business	Stake	Consideration (USD million)*
2005	Liberty Shoes Limited	Pantaloon Industries	Retail (Footwear)	51%	2.8
2005	Indus-League Clothing Limited	Pantaloon Industries	Retail Clothing	68%	5.3
2005	Odyssey India Limited	Deccan Chronicle Holdings	Leisure retail chain (books, music, toys)	100%	13.6
2005	Home Solutions Retail India Limited (Pantaloon Subsidiary)	Unitech India (Real Estate Group)	Retail (Home Furnishings)	33%	5.5
2005	Premier Foods Plc, UK (Brands Typhoo, London Fruit & Herb)	Apeejay Surrendra group	FMCG (Tea)	100%	153
2006	Nutrine Confectionery Company Limited	Godrej Beverages & Foods	FMCG	100%	55.5
2006	Bistro Hospitality	TGI Friday's, USA	Restaurant (Food Retail)	25%	N/A
2006	Hair oil brand Nihar from Hindustan Lever Limited	Marico	Personal Care	100%	55.5-66.6
2006	Eight O'Clock Coffee Company, USA	Tata Coffee	FMCG (Coffee)	100%	220
2006	Bouvet-Ladubay (wine brand of French champagne group Taittinger)	United Breweries Group	Wine	100%	15

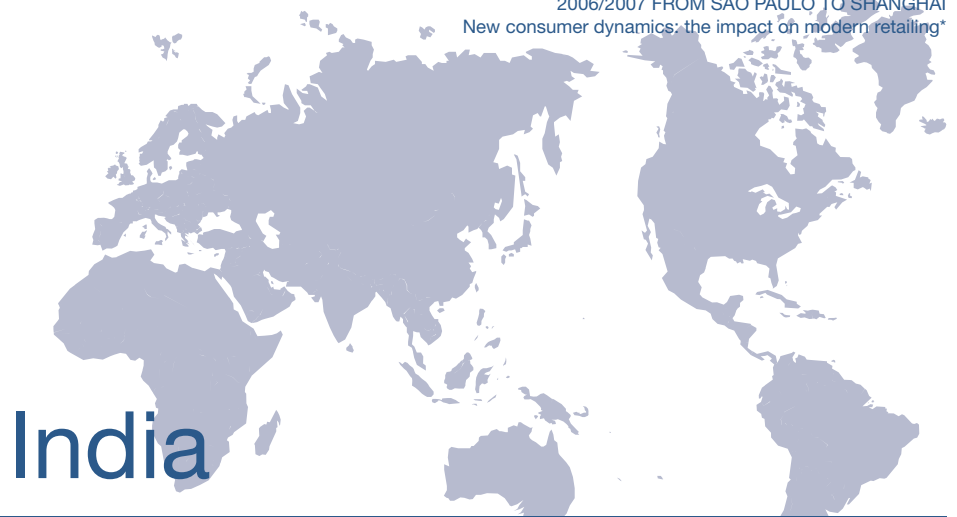
* 1 USD = INR 45; 1 USD = GBP 0.52



*M&A as a strategy for retail
format diversification*

2005 was a significant year for M&A activity in Indian retail. To expand into new formats and offer a wider variety of products, retailers actively scouted for joint-venture opportunities and acquisitions. Pantaloon Retail, active on this front, entered into strategic alliances with Planet Sports, Liberty Shoes and Unitech Group to expand its range of premium offerings, footwear and home solutions products.

With the addition of global retailers entering the Indian market, competition is increasing for domestic retailers. With the relaxation of FDI norms, the retail and consumer sector is expected to witness increased activity in the coming year. In the first five months of 2006, India recorded an overall USD16 billion worth of mergers and acquisitions, signaling an increasing number of fast-track companies and sustained acceleration of FDI flows.



RETAIL AND CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

While the low rate of penetration of the modern trade presents a huge opportunity for retailers, the vast size and fragmented nature of the market also raise a host of specific challenges.

CHALLENGES

Lack of Infrastructure and Logistics

India is a fragmented country with 70% percent of the population residing in rural areas. The absence of a strong infrastructure and logistics system means that reaching consumers and transporting goods is difficult. With growing urbanisation the necessity of robust roads, highways and public transport systems are essential.

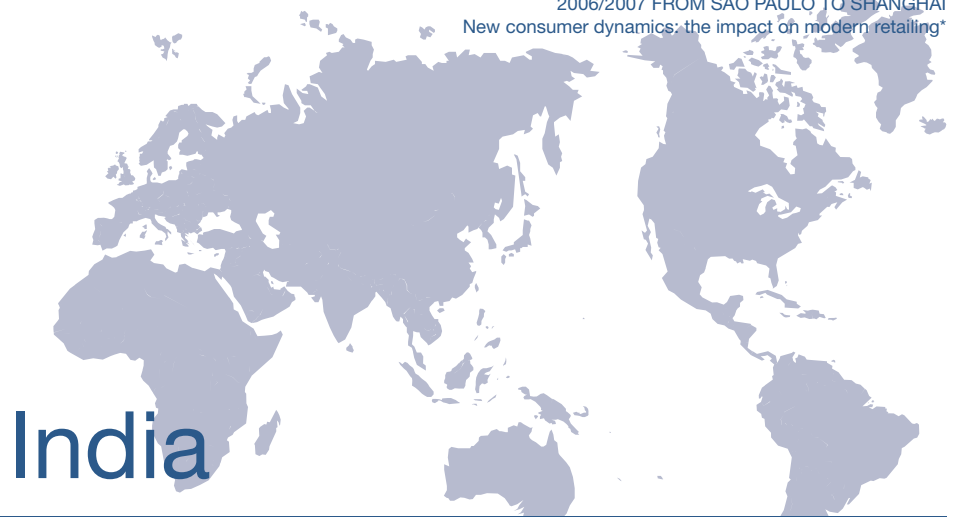
For example, the average daily traffic volume on highways of 39,000 passenger car units exceeds the highway capacity of 15,000 units. In addition, the average load carried by trucks in India of 7 tonnes is very low by global standards. Logistics costs are currently between 10-12% of total GDP.

The Indian government is making investments into funding state highways; as a result, an overall decline of logistics costs will occur.

Supply Chain Bottlenecks

Adopting technology-based solutions will enable retailers to improve customers' shopping experiences, manage profitability and address operational challenges. A competitive retail environment will force Indian retailers to upgrade and adopt key technologies such as bar-coding, point of sale (POS) systems, handheld terminals (HHTs), and tablet personal computers (PCs) in order to improve efficiency and supply chain management. Global factors are also encouraging the adoption of these technologies in India such as:

- Increasing demand from overseas buyers to accept only bar-coded products.
- Worldwide demand for efficient and automated supply chains for product movement from point of manufacture to its point of sale/consumption.
- Global movement towards closer integration between suppliers and buyers as a requirement for lowering end product costs.



Retailers' increased bargaining power

Radio Frequency Identification (RFID) technology and bar-coding are two technologies that Indian retailers could adopt in order to improve efficiency, manage stock, improve billing time and enhance customer service.

In April 2006, Pantaloon, India's largest retailer contacted approximately 20 FMCG companies and demanded 5% higher margins for products sold at its Big Bazaar and Food Bazaar outlets. Pantaloon demanded higher margins based on the following:

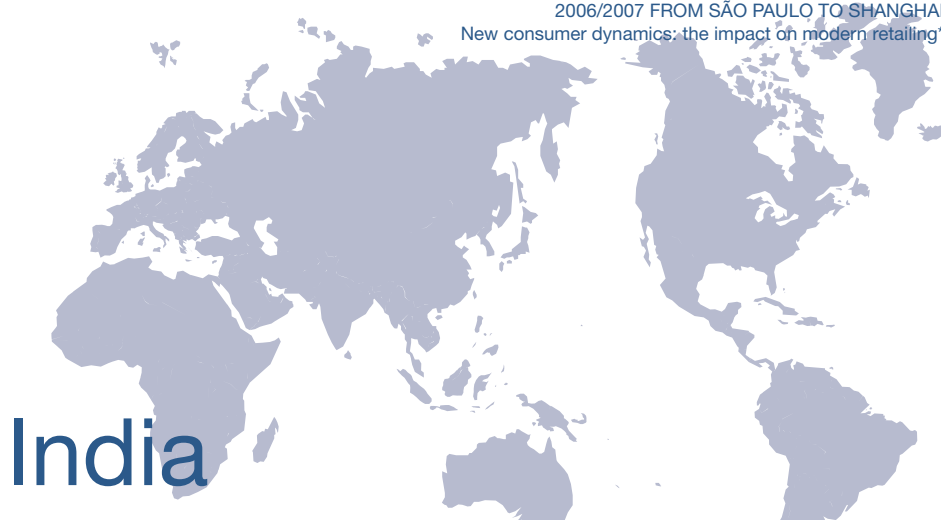
- Future consumption patterns.
- Higher throughput per store, costs of contact and increased expenses of modern retail operations.
- Increased visibility of FMCG brands through modern retail formats.

Despite significantly higher costs of operations, retailers earn the same margins as local mom-and-pop establishments i.e. between 8-12%. In this high-growth retail industry, FMCG companies, which have traditionally dominated this fragmented marketplace and enjoyed high profits, will now have to address retailers' increased bargaining powers.

Availability and high costs of real estate

Availability of quality retail space is critical to enable the anticipated rapid growth of modern retailing in India. Though the country is expected to have 220 malls and 87 million square feet of retail space by 2007, there is lack of efficient management amongst malls; only three to four malls in India are run as a central operating unit. Ownership is fragmented and this lack of central management typically leads to poor levels of mall management and maintenance. Appropriate location of malls, adequate infrastructure (i.e. parking space, proper layout and design) and professional mall management are some of the key features that retailers look for in identifying rental space.

With most Indian cities undergoing rapid urbanisation, increasing costs of retail space are a growing concern among retailers. The preferred form of real estate acquisition is through long term leases. With the demand for commercial properties remaining strong, the cost of real estate in most top tier cities has been soaring in the past two years, thereby escalating the lease rentals for organised retailers. The current average lease rentals across some of the top cities in India range from Rs.88 per square feet per month to as high as Rs.120 per square feet per month. On average, lease rentals account for between 7-8% of the revenue and 40-45% of the non-material cost for retailers. Unless real estate costs stabilise, most retail business will take a longer time to break even.



Inadequate availability of skilled labour

With new players entering the retail industry and existing players planning massive expansion, there has been a surge in demand for skilled retail resources. However, this demand is not being met by a readily available supply of talent. There is a growing concern about the paucity of trained retail personnel both at the store and managerial levels.

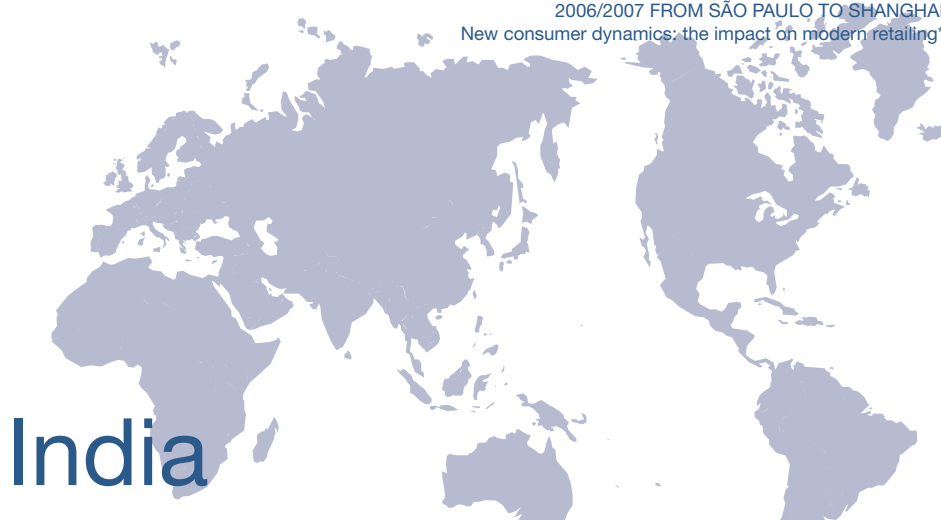
While there should be no manpower shortfall in India, given its large working population, the gap lies in finding people with the right hard and soft skill-sets, like customer orientation and selling. Proactive training is a key imperative for Indian retailers. Some retailers are partnering with management institutes to develop specific training programmes for staff. For example, Pantaloon has partnered with a management institute to offer specialised courses in retail management. Some retailers have taken the step of establishing their own retail schools, such as RPG Institute of Retail Management.

Fraud in retail

Fraud and theft (i.e. employee pilferage, shoplifting, vendor frauds and inaccuracy in supervision and administration) costs between USD0.12 to 1.13 billion annually; this constitutes approximately 2% of the organised retail sector's revenues. These losses occur despite the use of CCTV (Closed Circuit Television) and anti-shoplifting systems by large retailers. The loss due to retail theft or inventory shrinkage is about 0.3% of retail revenues in India, compared to 0.5% globally. Ultimately, consumers are the most hurt by employee theft since they pay a higher price for goods. Shoppers Stop Chief Executive Officer states, "We focus on reduced shrinkage and the introduction of a perpetual inventory count system. There is also a loss prevention team to track this down." Shoppers Stop's inventory shrinkage declined from 0.61% from last year to 0.54% in 2005.

Tapping the rural Indian market

The spending patterns of rural consumers are evolving. Instead of producing the largest part of their own food, rural families are spending larger amounts of their funds towards basic food items such as eggs, milk products, vegetables, beverages and processed foods. This "commercialisation of food" represents a tremendous opportunity for organised food retailing in rural India.



OPPORTUNITIES

Low penetration of
modern trade

India's retail market is largely dominated by unorganised players, representing a major growth opportunity for modern trade. The share of organised retail, currently at 4%, is expected to increase by 9-10% by 2010⁷. It will offer scale and increased visibility to products and brands. Organised retailing will enhance the economy through increased employment, agriculture and sourcing of products and services from India⁸. For consumers, it will also provide increased access and reach to products and services. With consumers' changing habits and preferences and their ability to use several retail formats, India's retail industry is evolving towards an inevitable modernisation.

Young, upwardly mobile
consumers

With the IT/BPO boom in India, a whole younger generation has access to a disposable income that their parents could only dream of in their youth. India's population, with a median age of 24, is the youngest consumer segment in the world. It presents an attractive and lucrative opportunity for retailers. Young Indian consumers are unapologetic about indulging their desires and with the advent of easier access to credit, a "buy now, pay later" culture is slowly emerging. These consumers are increasingly spending on a wide variety of products and services including eating out, movies and theatre, clothing, consumer durables/electronics and personal care items⁹.

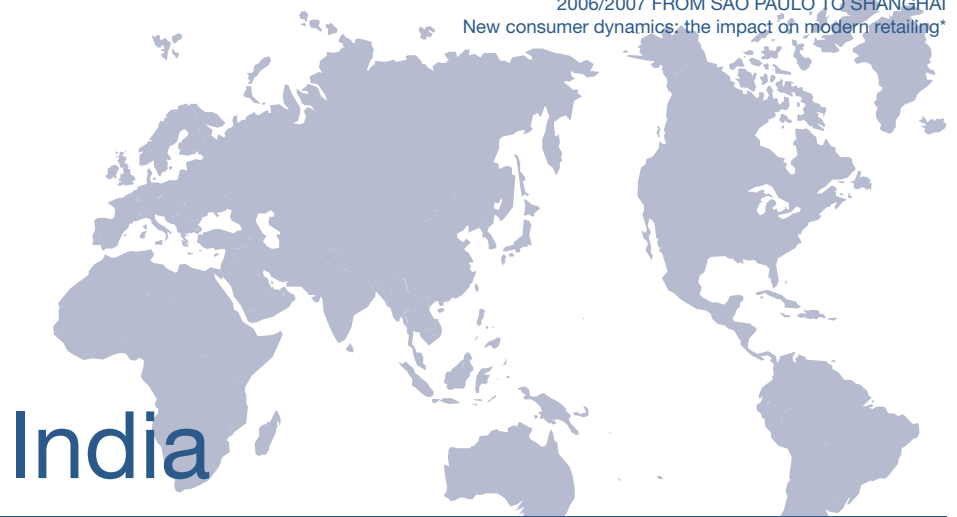
Franchising as a
preferred entry route

FDI restrictions in retailing have not deterred prominent international players from entering India and franchising has, thus far, been the preferred entry route. US-based Tommy Hilfiger, Netherlands-based SPAR International and UK-based Costa Coffee all chose franchising as the mode for entry into India. Estimates from the Franchising Association of India reveal that nearly 800 franchise systems are operating in India and new franchise developments are worth USD110 million annually.

Till 2006, FDI in retail was not allowed and franchising was the only mode of entry available. Even with 51% FDI introduced in January 2006 in single brand retail, many companies prefer franchising as an entry route to test the market till further control is allowed. Franchising operations are becoming more popular in geographically vast and culturally diverse nations such as India. The size and spread of the Indian market coupled with local variances of consumer preferences implies that expansion through local franchisees enables entrants to understand market realities.

7,8 PricewaterhouseCoopers, "The Rising Elephant: Benefits of Modern Trade to Indian Economy."

9 KSA Technopak Consumer Outlook.



TRENDS

Increasing competition in the retail market

New entrants such as Reliance, Bharti Enterprises and the AV Birla Group will compete against well-established retailers, such as Pantaloon Retail, Shoppers' Stop, Trent, Spencer's and Lifestyle stores. Foreign retailers are keenly evaluating the Indian market and identifying partners to forge an alliance with in areas currently permitted by regulations.

With an estimated initial investment of USD750 million, Reliance is planning to launch a nationwide chain of hypermarkets, supermarkets, discount stores, department stores, convenience stores and specialty stores. These 5,500 stores will be located in 800 cities and towns in India.

Increase in private labels

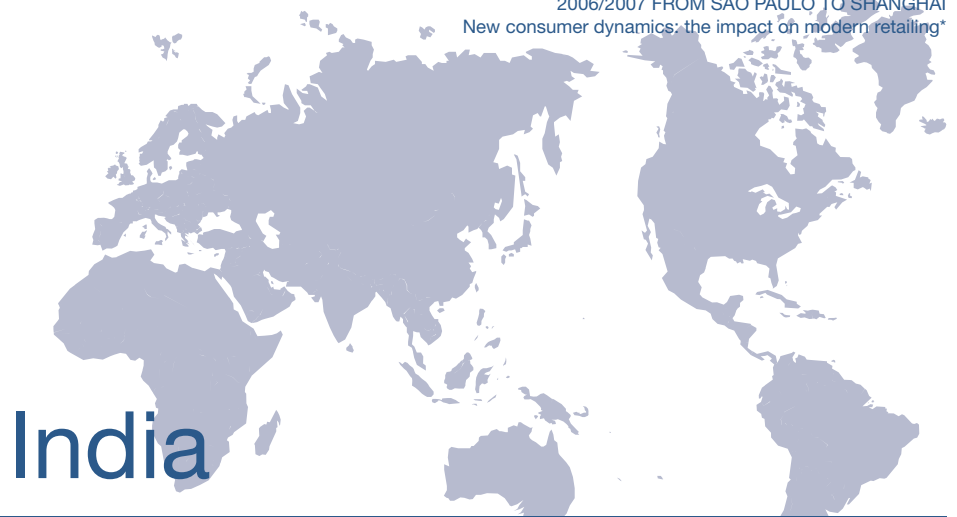
With the emergence of organised retail and modern retail formats, private labels have been gaining significance. They enhance the profitability levels of product categories, increase retailers' negotiation powers and create consumer loyalty. More retailers are introducing their own brands in all categories, including apparel, accessories, footwear or groceries. For example, many apparel retailers like Westside, Globus and Pantaloon offer between 50 to 80% of private labels within their stores. These own brands also do not have to manage intermediaries since retailers maintain oversight of the supply chain.

FMCG is another sector where private label penetration has been on a rise. According to AC Nielsen, private label penetration is growing among FMCG products in most supermarkets with groceries accounting for 45.9% of private labels, packaged foods for 25.7% and homecare items for 16.4%. In India, retailers' private labels are cheaper by 20 to 25% as compared with organised FMCG majors.

New product categories

With exposure to international trends and lifestyle, consumers are demanding more specialised products, two of which are examined below:

- Jewellery—Industry watchers estimate that the gems and jewellery industry in India will grow by between 15 to 20% in 2006. As one of the fastest growing sectors in the Indian economy, the industry accounted for 15% of India's total exports in 2005. In value terms, total gem and jewellery exports grew to USD17 billion in 2005. In light of the significant growth potential, the government plans to create a committee to study the industry's potential. It is estimated that the branded jewellery market in India will grow by 40% per annum to INR100 billion (USD2.28 billion) by 2010.



Expanding to Tier II and III Cities

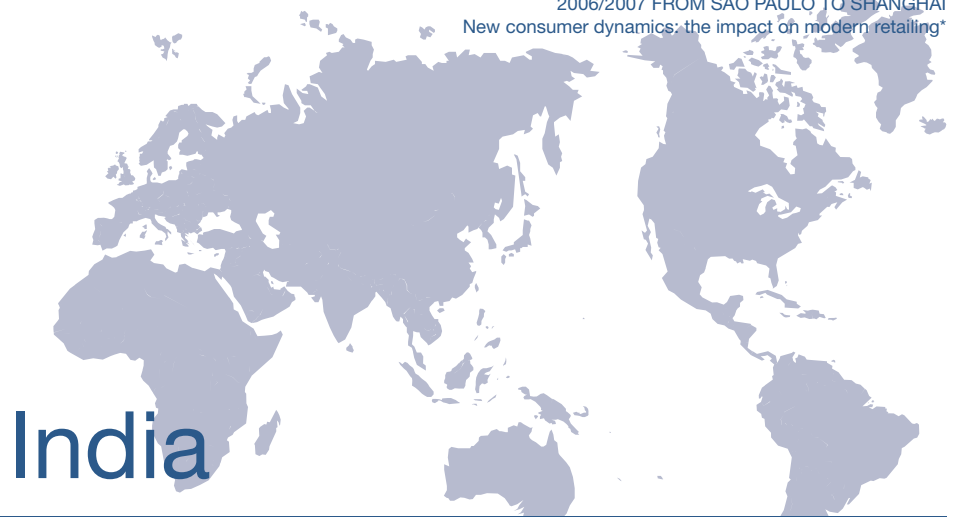
- Liquor and Wine—Consumption of wine in India is growing at the rate of between 25-30%. While the annual consumption of wine in India is still limited to 0.006 bottles per capita, it is expected to increase by 7.0 million litres annually by 2008. Alcohol sales in India amount to about 675 million litres a year, worth almost USD4.25 billion. Wine currently accounts for only 0.84% of the market, but its sales have increased by over 22% over the last three years.

Indian retailers are planning to extend operations into Tier II and Tier III cities as heightened IT offshoring activity in these locations have increased consumers' disposable income. The population in these cities is typically well-educated and willing to purchase goods and services. Some major retailers, like Globus and Pantaloon, have already begun building a retail presence in Tier III cities before many retailers have finalised their Tier II retail operations.

- Globus intends to occupy a total retail space of over a million square feet by 2011, with an investment of between INR3 to 4 billion (USD67 to 89 million). Senior staff at Globus indicate that many of their loyal customers are from Tier III cities and these expansion plans will improve the access to these customers.
- Raheja's Hypercity Retail (India) will build three stores in 2006. The stores will be located in Tier-I and Tier-II cities and will target the middle class segment. The stores will stock a wide range of goods, including food, grocery, apparel, durables and home furnishings.

Foray into retail agribusiness

India's most prestigious business houses and global retailers are planning to enter retail agribusiness. Market entrants plan to invest in the entire value chain, moving goods "from the farm to the fridge at home." Viewed as India's next "sunrise sector," retailers are employing contract farming as a means of boosting their ventures. Contract farming enables farmers to access land, manpower and farming skill without having to purchase land. Of the total cultivable land of 400 million acres in India, contract farming represents seven million acres thus indicating a tremendous opportunity. For pure corporate contracts between farmers and companies, only 200,000 acres are used.



Experimenting with formats

Selecting the right retail format is essential in modern retailing. The difference between urban and rural customers is one of the reasons why multiple formats are required in India. Local conditions and insights into buying-behaviour shape the format choice. No single format will be suitable for an all India strategy and selecting the relevant format is a key success factor.

Hence, ITC is experimenting with a rural hypermarket through its “Choupal Sagar” format, which combines a grain procurement and storage centre with the mall. The underlying premise of this model is to capture the farmer’s visit to a “mandi” (wholesale market) to sell his produce and to offer a range of products and services to capitalise on the ready availability of cash after the sale.

Home décor and improvement retailing

According to one market survey home improvements (38%) and leisure holidays (37%) as the two pursuits Indian consumers are willing to indulge in¹⁰. Many of the world’s leading home fashion brands are available in India through domestic retail outlets. The market for home décor, including accessories, hardware, furniture and furnishings, is estimated at USD14.4 billion. Of this, only six percent is organised, representing a tremendous opportunity.

Some players include Home Town, the flagship delivery format of Home Solutions Retail India Limited, a subsidiary of Pantaloon Retail India Limited. Six outlets of Home Town will be opened by 2007 and will meet the needs of customers planning to build, furnish and decorate their homes. For example, stores will offer building material, paints, tiles, electrical and plumbing products and services, furnishings, furniture and consumer durables.

International players entering this sector include Index Living Mall Company. This home furnishings retail chain, has signed an agreement with an Indian partner to open a franchise in India next year. Index Living Mall is expected to be the first foreign home furnishings chain to open in Mumbai and has yet to announce its Indian partner.

Case Study I

Multi-format development by a domestic retailer

KEY DRIVERS

Founded by Kishore Biyani in 1987, 'Pantaloon Retail India Limited' (PRIL) is a pioneer in organised retailing in India with a diversified presence in food, apparel, books, music, leisure and entertainment, financial products, home solutions and other businesses through multiple delivery formats catering to both lifestyle and value products. Over the years, PRIL has emerged as a fully-integrated retail player controlling the entire value chain. Future Group was formerly known as Pantaloon Knowledge Group. Pantaloon Retail India Limited (PRIL) continues to be the name of the company.

Which strategic steps have allowed PRIL to become a leading retail player? How has the group met the challenges of retailing in India?

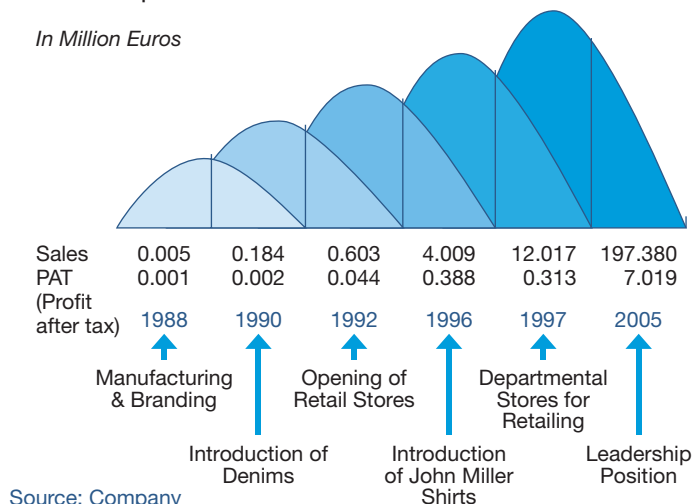
Background



In order to face the many challenges of PRIL's businesses have been organised along the following verticals:

- Future Retail
- Future Logistics
- Future Capital
- Future Brands
- Future Media
- Future Space

Future Retail is to be the core vertical, with the other verticals directly or indirectly serving it. For instance, Future Logistics will drive efficiency across businesses, Future Brands is to be the custodian of all present and future brands (developed or acquired), Future Capital is the financial arm that will tap into consumer savings as well as serve as a medium for customers to pay, Future Space will manage properties and malls, while Future Media will capitalise on media opportunities within retail.



Strategic Blending of Multiple Formats and Private Label Management

The experiences of Wal-Mart and other successful retailers illustrate that retail formats need to be tailored to local consumers' preferences. PRIL maintains a competitive advantage by catering to Indian consumers' needs and has capitalised on its first-mover advantage by experimenting with product offerings and adapting them to evolving preferences.

Based on current trends, organised retailers who had initially stocked national brands have now begun to expand their in-store/private label selections. This is because 'own' labels yield a relatively higher gross margin

of between 54-60% as compared to margins of between 28-35% earned by stocking national brands. The most important factor determining the success of a private label is scale. As volumes increase the fixed cost gets distributed, thereby decreasing as a percentage age of sales. Based on large size, PRIL effectively manages its internal brands while simultaneously offering lower prices to end-consumers. The group currently derives 22% of revenues from its private labels.

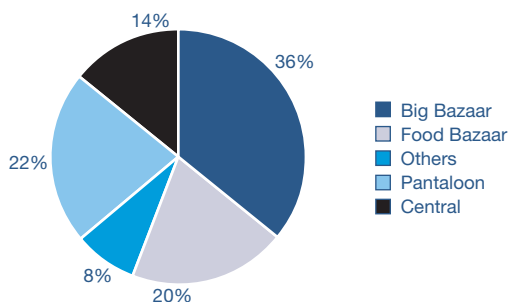
Lifestyle vs. Value Retailing

PRIL maintains a presence in lifestyle retailing through its 'Pantaloon' & 'Central' stores, while both Pantaloon and Central cater to middle- and upper-middle income consumers. Based on PRIL's latest financial results, Lifestyle Retailing accounted for 35% of overall revenues. With a focus on enhancing private label penetrations, PRIL plans to increase the number of season styles from four to seven to ensure that merchandise will be renewed every 45 to 50 days, as opposed to the current 90 to 120 days. This increased frequency of launching new fashion is expected to result in increased footfalls and increased turnover with a lower stocking period and amount.

Since lifestyle formats are dependent on the availability of prime retail real estate, the scalability of these formats is restricted to Indian metros.

Unlike lifestyle retailing, value-based purchases are dependent on income levels and are driven by the desire for quality goods with greater variety. PRIL aims to capture the middle-income consumer with its value retailing formats – Big Bazaar (hypermarket) and Food Bazaar (supermarket) – with low-margin retailing accounting for 50% of its fiscal year 2005 revenues. Also, approximately 50% of Food Bazaars are contained within Big Bazaar stores.

Revenue Mix FY-2005



Source: Company

Big Bazaar: The group is enhancing private label-penetration both in its apparel and FMCG offerings. For example, PRIL recently introduced proprietary brands – 'Caremate' and 'Cleanmate' in its detergents and soaps categories. It has also undertaken an initiative to expand the number of categories introduced within each of the Big Bazaars by including durables, home furnishings, etc. Big Bazaar's private label strategy is clearly reaping benefits for PRIL since this format is its largest revenue earner.

Fashion Station: This apparel-based format is medium-sized and houses the entire private-label collection of Big Bazaar. Primarily a thematic store, Fashion Station is an attempt to offer fashion forward products to mass markets.

Food Bazaar: Low margins are the main feature of this supermarket. PRIL manages margins by using its efficient supply chain network to ensure higher margins from FMCG companies, as well as lower procurement costs on the basis of substantial purchase volumes.

PRIL has concentrated a majority of its expansions on value-retailing due to the easy scalability of these value formats. PRIL intends to increase the number of its 'Big Bazaar' outlets from 26 to 80 by 2008. The Group also plans on increasing the number of its 'Food Bazaar' outlets from its present 40 to 150 by the end of 2008. PRIL is also looking to increase the number of 'Fashion Station' outlets from its current 4 to approximately 50 by 2010.

Home Improvement

Although PRIL is yet to roll out its 'Home Solutions' stores on a large scale, it aims to have approximately 1.7 million square feet of additional retail space dedicated to this format by June 2008. The company is targeting both lifestyle and value-conscious consumers by offering a combination of different formats under the 'Home Solutions' banner – E-zone, MeLA, Collection – i, Home Town, Furniture Bazaar and Electronics Bazaar, among others.

Early Mover Advantage – Real Estate

Availability of quality retail space is critical to the growth of modern retail trade. Almost all retailers are increasingly concerned about the spiralling real estate costs in India with the highest cost incurred in establishing retail ventures being the cost of lease rentals. The only way retailers can survive this squeeze is by becoming an 'anchor tenant'. An anchor tenant typically commands a discount of 30-45% on lease rentals and is responsible for attracting the footfalls. PRIL has been quick to endorse this strategy and today is one of the most sought after 'anchor tenants'. Out of the 300-odd malls under development in the next three years, Pantaloon has signed up with 100 of them. This rapid "land grab" will enable PRIL to leverage its first-mover advantage on a pan-India basis. The Group currently has approximately 3.5 million square feet spread across several formats, and is expected to have almost 10 million square feet of space by 2010.

According to industry estimates, lease rentals in Tier-II cities are almost 40-50% lower than those in top tier cities. Here again, PRIL has been quick to establish its presence in Tier-II cities – PRIL's real estate fund, Kshitij 1, which has a corpus of USD80 million at its disposal, is understood to have invested in projects in Tier-II cities like Ahmedabad, Baroda and Surat. PRIL expects to have nearly 400,000 square feet of retail space by 2008 in these destinations.

Deep Pockets: Access to Private Equity Funding

To finance its ambitious growth plans, PRIL has gained access to a large pool of funds. The Group's financial services arm, 'Future Capital' is an incubator for its expanding business lines:

Real Estate Funds: In an effort to finance its real estate ventures, PRIL has floated two dedicated real estate funds – 'Kshitij' and 'Horizon'. While 'Kshitij' is primarily meant to be the retail development arm of PRIL, the 'Horizon' fund, which has a corpus of USD350 million, is an international fund that will solely finance large city formats.

Indivision Capital: This fund is targeted at domestic consumer goods and has a corpus of USD400 million, with some of the world's most reputed families investing in the fund. Goldman Sachs is an anchor investor with a commitment of USD100 million.

Strategic Partnerships (Specialty Retail & Allied Ventures)

In order to remain competitive in the long-run, retailers need to differentiate themselves from their competitors. Here again, PRIL has been proactively gaining a 'specialty' retail presence by either forging JVs with experienced players or establishing its own stores, if required.

Apparel - Strategic Partnerships: Some of these alliances include PRIL's 49% stake in Planet Sports Private Limited (sole franchisee of Marks and Spencer, Wilson, Puma Speedo and Converse in India) and its 50-50 JV with Lee Cooper International Limited to distribute and retail its eyewear and footwear brands in India.

Other Specialty Retail Ventures: Other ventures include the Group's 50-50 JV with Liberty Shoes (India's second largest footwear manufacturer and its foray into wholesale retailing (B2B format modelled along Wal-Mart's Sam's Club).

Key takeaways

By securing retail space across the country and building a financial services arm, PRIL has successfully acquired the means to develop a multi-format retail strategy and cater to the great demands of India's fast changing consumer society.

Case Study II



Market expansion of an international trading and retail group

KEY DRIVERS

METRO, with a sales turnover of 55.7 billion in 2005, is the second largest trading and retailing group in Europe and the fifth largest in the world. It runs widely diversified operations in 30 countries with 2,447 stores, 250,000 employees and approximately 12 million square meters of retail space.

Indian government policy allows FDI in the wholesale cash & carry segment on a case-by-case basis. However there was no clear definition of the difference between retail trading and cash & carry wholesale trading. Metro having obtained FDI approval from the authorities required entry-assistance and advice on minimising regulatory risks.

Cash & Carry in India

METRO opened two distribution centres in Bangalore in the last quarter of 2003. These distribution centres offer business customers access to over 8,000 food and 9,000 non-food items in different pack sizes. METRO employs 750 individuals and serves approximately 160,000 registered businesses customers¹. Over 95% of the merchandise for METRO's Indian operations is sourced locally from large- and small-scale industries. The group has invested over USD43 million in its Indian operations in order to build a modern infrastructure complete with humidity and moisture control facilities.

METRO maintains close contact with customers by sending a "METRO Mail" every two weeks to update them about special offers. Staff visit customers' premises regularly to learn more about their needs and a dedicated customer service team is available at each centre to manage issues such as product complaints, service and repairs².

METRO will invest a further 300 million euro in order to develop operations and extend market penetration. The company's chief executive Hans-Joachim Korber indicated that METRO's expansion is hindered by the Agricultural Produce Marketing Cooperatives Act, which regulates and restricts trade in agricultural products. The Government of India is currently urging state governments to amend the APMC Act to allow trade in agricultural products and eight states have already removed it.

METRO, keen to expand operations in India is in the process of carrying out feasibility studies for opening stores in 33 targeted cities with populations of over one million. With two stores in Bangalore, the German Cash & Carry operator will open three additional outlets in Kolkata, Hyderabad and possibly Chennai.

Key Strategic Levers

Indian Supply Chain

Indian supply chain management is evolving and for rapid economic growth, modern supply chain structures and systems are imperative. Currently in India, there is 20-40% wastage for perishable produce due to multiple intermediaries, wastage during transportation and storage, high cycle times and an absence of cold storage systems. The supply chain can be made more efficient through economies of scale in procurement and transportation, bulk storage, trend forecasting and analysis of sales patterns to minimise inventory, improve fund management and enhance service levels in terms of availability.

^{1,2} www.metro.co.in

Metro initiatives

METRO embarked upon several internal and external initiatives to improve supply chain management.

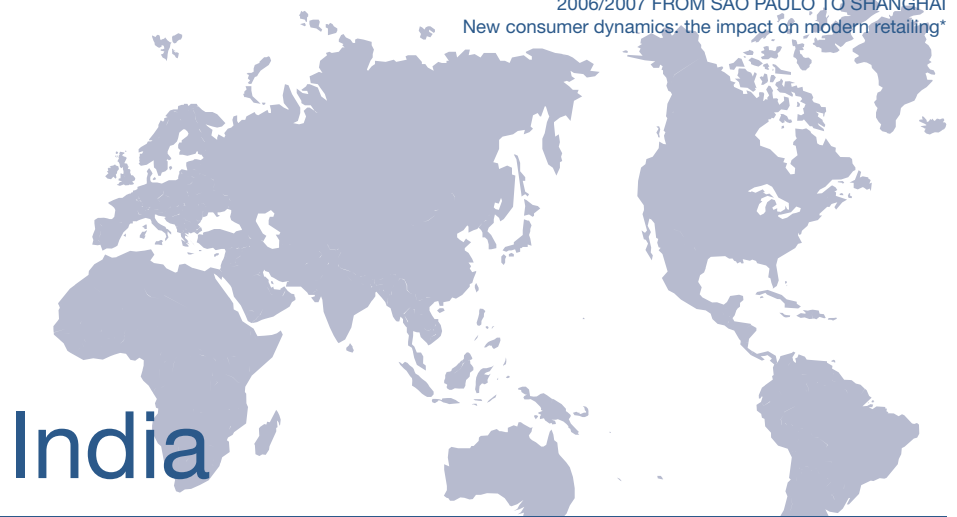
- METRO launched a supplier relationship management portal to modernise its supply chain. The portal is an interactive web-based tool that will strengthen partnerships between METRO and its suppliers. METRO has about 600 suppliers in India and two distribution houses in Bangalore³.
- METRO and the Government of Karnataka partnered to improve the infrastructure for fisheries in the state. The company assumed a project to develop a modern fish auction centre in Mangalore at an estimated cost of Rs. 5.7 million. The auction centre is scheduled for completion by June 2006 and will maintain quality and hygiene and extend the shelf life of fish. METRO Cash and Carry built two similar auction centres in Tamil Nadu during 2005⁴.
- METRO launched a pilot project for farmers at Hosekote near Bangalore. The pilot project aims at providing knowledge and training to local farmers to clean, sort, grade, and pack agriculture produce according to the company's global standards. These distribution centres fetch fair prices for farmers and reduce wastages.

PRICEWATERHOUSECOOPERS ASSISTED IN THIS CASE STUDY BY PROVIDING THE FOLLOWING SERVICES:

- Advice on policy issues relating to FDI, especially in the trading sector.
- Leveraging existing relationship with senior policy makers to discuss the issues and obtain a clear definition of retail trading and wholesale cash & carry.
- Assistance with operational advisory issues such as technology and supply chain.

3 Author unknown, "METRO Launches SRM Portal." Indian Business Insight (July 31, 2005).

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Poland



Area ('000 sq km)¹: 312.7
(US 9,600 – EU25 3,981 – World 133,700)

Capital²: Warsaw
(Number of inhabitants: 2.4 million)

Population (million): 38
(US 296 – EU25 459 – World 6,000)

Median age³: 37 years

Nominal GDP (USD billion): 303.2
(US 12,487 – EU25 13,447 – World 44,183)

Nominal GDP (USD billion at PPP): 485.6
(US 12,487 – EU25 12,657 – World 59,763)

GDP per head (USD at PPP): 12,723.3
(US 42,129 – EU25 27,538 – World 9,962)

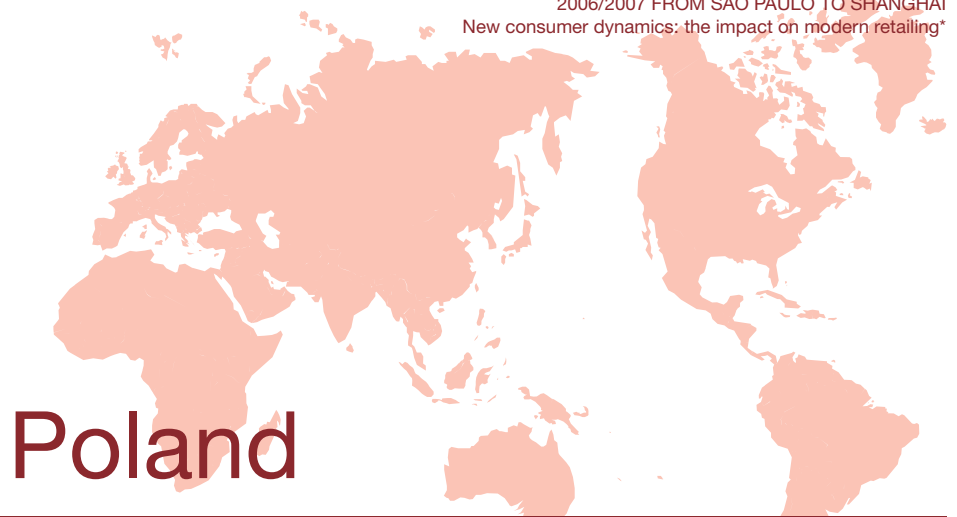
Currency³: Złoty (PLN)
(USD1 = PLN3.2)

Languages³: Polish

Main religions³: Roman Catholic (90%)

Government type³: Republic

Sources: () Economic Intelligence Unit 2006 data,
(¹) World Bank 2005, (²) City Population,
(³) CIA Fact book



Poland

GDP AND CPI
*GDP growth picked up
over 2005*

ECONOMIC OVERVIEW

*A positive outlook driven by growing domestic demand
and EU accession*

Poland's economy showed a significant improvement during the year following an unsuccessful start in 2005. Real GDP growth in the first quarter of 2005 was at a 2.1% year-on-year level compared with 4.2% in the fourth quarter. However, it should be noted that Poland's economic indicators were disrupted by the statistical measurement changes due to accession to the EU in 2004. Exports remained the main growth factor in 2005, while the dynamics of domestic demand were lower than GDP. Positive contribution of net export was recorded despite the disadvantageous exchange rates from the exporters' point of view. The lower-than-estimated domestic demand was driven by an increase in investment on the one hand and limited by the weak growth of consumption demand on the other.

GDP and CPI

	2002	2003	2004	2005
GDP growth (%)	1.4	3.8	5.3	3.4
CPI (%)	1.9	0.8	3.5	2.1

Source: EIU, July 2006

Steadily decreasing inflation

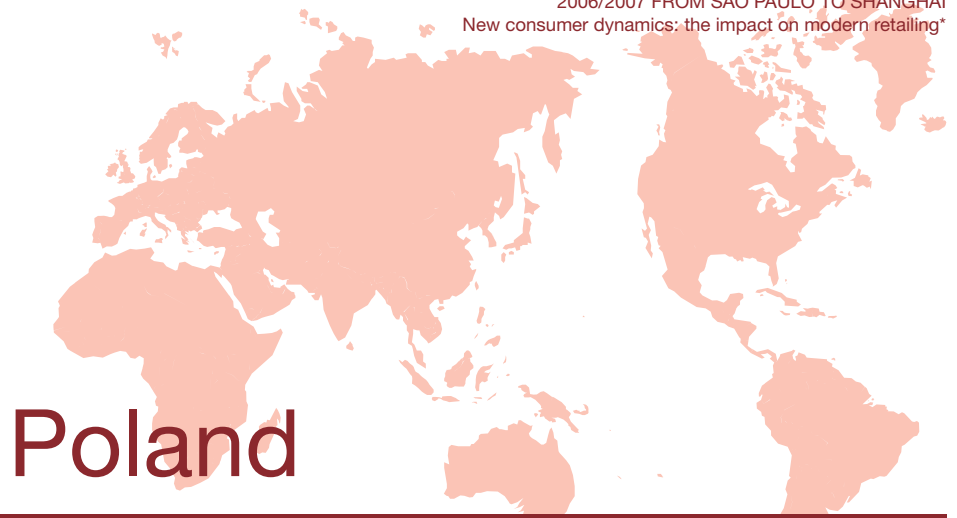
The average CPI decreased constantly throughout the year mainly as a result of the falling prices of food, clothing and footwear. Domestic cost pressures from the labour market increased – nominal wages in enterprises rose by 4.9% year-on-year – but, although unemployment is now falling slowly, it is expected that levels will remain high and prevent a sharp acceleration in wage inflation.

UNEMPLOYMENT
*EU accession is helping
to ease pressure on
employment*

Unemployment

	2002	2003	2004	2005
Unemployment rate (%)	19.7	19.9	19.6	18.2

Source: EIU, July 2006



Poland's unemployment rate, still the highest in the European Union, finally began to decrease in 2005. In the last quarter, the unemployment rate decreased to 15.7%, according to official statistics, which represents 2.7 million jobless people (versus 2.9 million in the last quarter of 2004). The vast majority of these people (86.1%) are not entitled to receive unemployment benefit. Almost one-third of the unemployed have been without a job for 24 months or more.

With people born during the baby boom of the 1980s still entering the market, Poland needs hundreds of thousands of new jobs to reduce unemployment among people aged between 15-24; the unemployment rate in this age group is currently at a dramatic level of 34.7%. Over the last two years, however, the situation has started to improve due, in part, to the job immigration towards the EU following accession.

ECONOMIC FORECAST

*Growing domestic demand will
drive future growth*

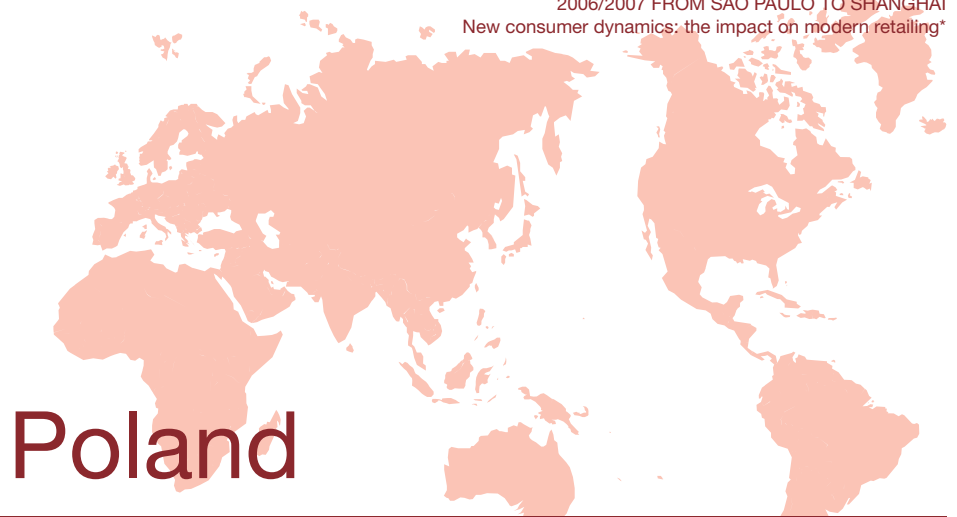
Key economic forecasts

	2006	2007	2008
GDP growth (%)	4.8	4.6	4.2
CPI (%)	1.3	2.0	2.3
Unemployment rate (%)	16.9	16.0	15.2

Source: EIU, July 2006

After a temporary slowdown in 2005, the Polish economy is expected to return to a stable growth path, and in the next few years GDP is expected to grow by approximately 4% per annum. Growth will be based on domestic demand to a larger extent than in 2005. Domestic demand will revive mainly due to investments (an estimated growth rate of 9.1% in 2006 and 9.3% in 2007) rather than consumption demand. It is predicted that EU funds will provide a strong growth burst and will also help to modernise the inefficient agricultural sector.

Poland is hoping that the favourable economic situation will reduce the number of unemployed; it is predicted that the unemployment rate at the end of 2008 will drop to 14.6%, according to official statistics. Nevertheless, Poland will remain a negative leader in the European Union in this category.



Poland

FOREIGN DIRECT INVESTMENT

An attractive destination especially for offshoring processes

REGULATORY ENVIRONMENT

Poland's legal framework is entering into increasing alignment with EU norms

FDI

	2002	2003	2004	2005
FDI (ARS m)	16,855	17,847	47,051	24,978
FDI (USD m)	4,131	4,589	12,873	7,724

Source: EIU, July 2006

In 2005 foreign direct investment in Poland was 40% lower than in 2004. Nevertheless, the downward trend has not affected Special Economic Zones. In 2005, PLN5.8 billion was invested in Polish Special Economic Zones (SEZ) and employment in those areas increased by 51%. The Polish Government has introduced 24 border changes, thus enlarging the area of Special Economic Zones by 1,000 hectares. In 2005, Special Economic Zones attracted 34 large investment projects, for example LG Electronics Mława, Johnson Controls, MAN Trucks and Michelin Poland. In the first half of 2006, LG Electronics decided to set up a manufacturing plant near Wrocław (household equipment and LCD sets), giving the region a growth perspective and attracting suppliers.

Membership of the EU is the main driver of the growing interest of foreign investors in locating their investments in Poland's Special Economic Zones. Increased confidence in the Polish economy combined with favourable tax regulations has encouraged many investors, especially from Asia. Companies that locate their operations in Special Economic Zones are entitled to tax allowances amounting to up to 50% of the total amount of money invested. Moreover, Special Economic Zones offer good infrastructure with well-developed utilities and facilities. Since 2005, investors have also been allowed to locate offshoring centres in Special Economic Zones. However, to make the SEZ fully attractive for such business, better office space needs to be developed.



Poland

Business process offshoring for a major consumer goods player

As a global leader in Foods, Home Care and Personal Care, Unilever takes active steps to become more competitive and speed up its growth. In June 2005 Unilever started to explore both in-house and outsourcing options for a range of transactional services in its European Business.

The main purpose was to simplify organisation and focus Finance resources on areas that add value to the business (e.g. business partnering). In October 2005, a due diligence phase allowed the preferred service provider, IBM, to collect more data and gain a fuller understanding of Unilever's current operations, before submitting final proposals. In December Unilever signed a contract with IBM to outsource transactional finance processes in the areas of purchase to pay (accounts payable) including expense claim processing and general accounting (general ledger & fixed assets accounting) and bill to cash, in a limited scope.

Unilever's Polish business was the first to implement the contract. The majority of transactional services were transferred to IBM office in Kraków. The remaining transactions are processed by the IBM office in Bangalore in India. In this stage of the outsourcing project, IBM works on implementation of its own system for electronic invoice filing and authorisation. The next step will be to introduce an electronic authorisation and booking system of employees' personal expenses. It will eliminate paper flow and unify the company employee's expenses rules across Europe.

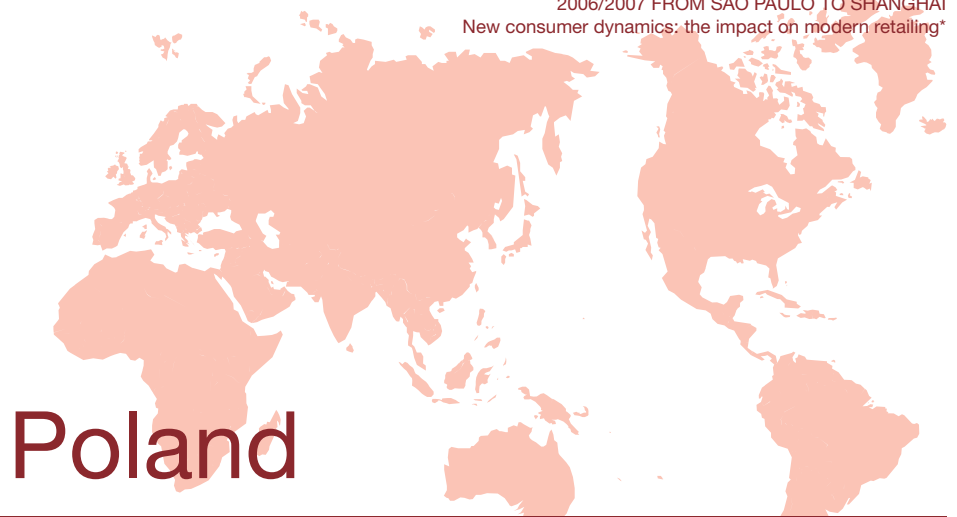
PROPERTY/REAL ESTATE REGULATIONS

EEA companies can usually purchase real estate without restrictions

Lack of local spatial plans makes construction a long-drawn process

Foreigners from countries other than those from the European Economic Area – EEA (the European Union, plus Iceland, Norway and Lichtenstein) are required to obtain a permit from the Ministry of the Interior and Administration prior to their acquisition of real estate. Citizens or companies of the EEA are generally not required to obtain any permit to acquire real estate or shares in companies that own real estates. There are exceptions to this general rule such as the acquisition of agricultural and forest land (until 30 April 2016) and the acquisition of so-called "second houses" (until 30 April 2009).

The Polish construction process is long and complicated; the obtaining of a building permit in Poland can take up to one year. The main problem for investors is the lack of local spatial plans. According to the Act of Spatial Management Planning, passed in March 2003, the development plans which



Poland

were enacted before 1995 expired on 1 January 2004. Currently, it is estimated that 70% to 80% area of Poland does not have valid local spatial plans.

For the investors, the lack of a local spatial plan (LSP) results in a longer construction process. Before applying for a building permit (BP), the investor has to apply for an outline building permit (OBP). Consequently, the construction process is composed of two procedures rather than one.

Enacting a new local spatial plan is very time-consuming and this process is not expected to speed up in the near future. At present, the heads of local authorities issue OBPs only for developments that are consistent with the current local neighbourhood. It is believed that taking advantage of spatial management studies as the basis for issuing OBPs will speed up the construction process.

There are also some fears related to the implementation of a new environmental law (Natura 2000), which could make the construction process even more difficult than it is now. This is due to plans for broadening special ecological zones which might result in the need to obtain additional permits and to conduct special ecological analyses.

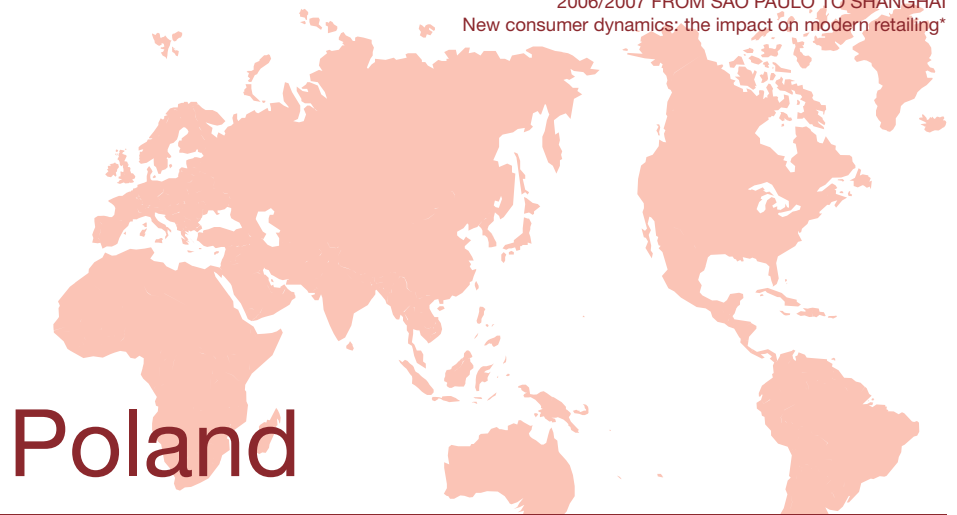
Before purchasing any real estate from the state or local government authority, care must be taken to ensure that no reprivatization claims have been put forward by former owners. Poland has not enacted a Reprivatization Act that would govern the rights of former owners whose properties were nationalised after the Second World War.

There are restrictions regarding the development of retail properties with floor space of more than 2,000 square metres under the Spatial Management Planning Act and the Building Act. All shopping facilities with floor space exceeding the limit mentioned above may be located exclusively in areas that are assigned a valid development plan for retail development.

Moreover, the ruling parties have been working on an additional act to restrict the expansion of large-area shops. In the draft of the new act, general administrative restrictions that could prevent the construction of shops of more than 400 square metres and prohibit locating shopping centres in small cities where there are less than 15,000 citizens are proposed.

*Reprivatisation claims need
to be verified before acquiring
government real estate*

NEW STORE OPENINGS
*Very regulated development of
retail space*



WASTE/RECYCLING

*EU regulations are
increasing costs by enforcing
waste recycling*

In October 2005, the Waste Electrical and Electronic Equipment Act (Recycling Act) came into force in Poland. The new law requires that waste electrical or electronic devices be collected and utilised. As of July 2006, waste collection has been simplified with the introduction of regulations enabling customers to return old electrical devices to the store when acquiring new equipment.

The Recycling Act was introduced in response to the European Union's directive 2002/96/WE, which obliges member states to establish a system for collecting and utilising electrical and electronic waste.

The new act is expected to result in a significant increase in the price of electrical and electronic equipment. Producers will have to bear additional costs relating to necessary technological improvements, the collection and transformation of waste and administrative charges. These costs will finally be passed to the customers in the form of price increases. Higher prices may result in lower turnover for retailers.

*Retailers need to prepare to
manage waste packaging*

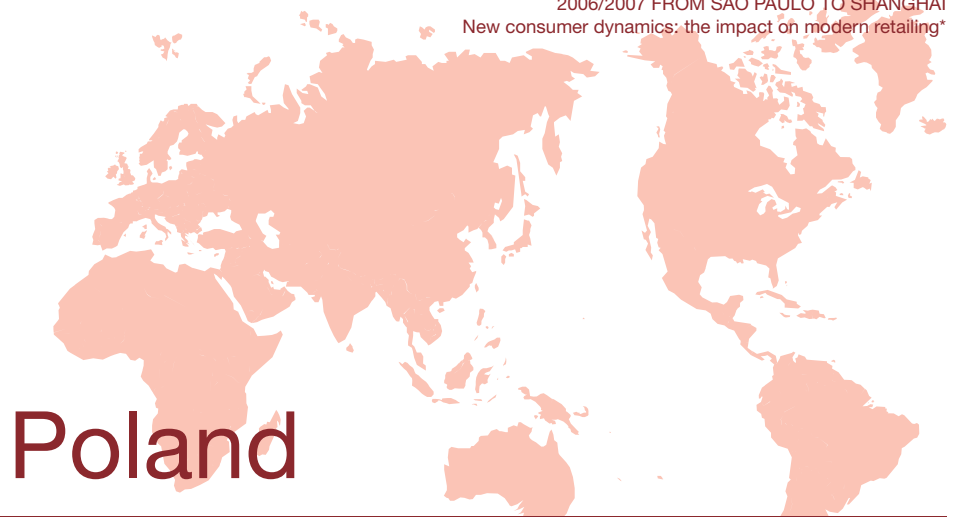
Another significant change in the law relates to the Waste Packaging Act, according to which retailers are obliged to collect waste packaging. In practice, this collection will cause many problems. First, stores are not adapted to perform this activity in terms of the amount of available space and personnel. Secondly, they are not prepared to meet higher safety standards. All the above may negatively affect retailers' operations and significantly worsen their financial performance.

INTELLECTUAL PROPERTY RIGHTS

*Greater safeguards are
being studied*

Polish legislators believe that increasing the level of protection of intellectual property rights in Poland will increase the degree of trust among entrepreneurs concerning efficient investments in development and innovation, and that it will prevent numerous cases of violation of such rights.

Work is underway in order to implement, in the Polish legal framework, a number of EU directives increasing the level of protection of intellectual property rights in member states, including Directive 2004/48 of the European Parliament and of the Council on the Enforcement of Intellectual Property Rights.



COMPETITION LAW

Well developed framework

Two important acts protect competition in the Polish market.

The first of the two, the Act of 1993 on Counteracting Unfair Competition with amendments passed in 2002, regulates unfair competition in business activities. The amendments passed in 2002 limited the promotion and sale of products without a profit margin in retail outlets with an area exceeding 400 square metres, the sale of own brand products in discount chains – up to 2% of their turnover, as well as limited promotional sales and trade using gift vouchers.

The second one, the Act on Competition and Consumer Protection, is a comprehensive antimonopoly act. It includes regulations aimed at counteracting both the collective and individual behaviour of entrepreneurs when harmful to competitors and the interests of other market players, contractors, consumers (prohibition of non-competition practices), as well as clauses on the administrative inspection of structural operations conducted by entrepreneurs (business combinations, purchase of shares, etc.), which may negatively impact competition on the market.

As of today, companies present on the market (including large scale retailers), have not faced any significant repercussions resulting from introduction of the above acts.

CORPORATE INCOME TAX

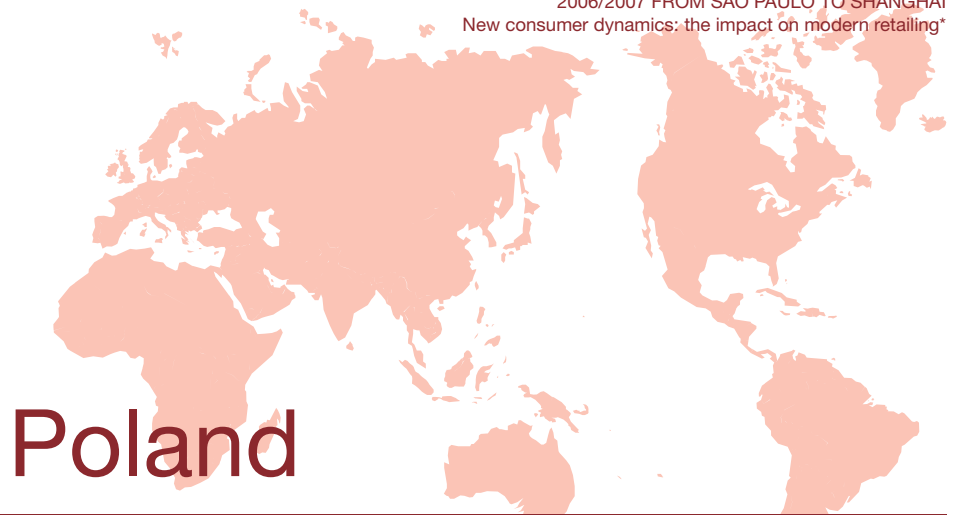
Set at 19%

From January 2004, the corporate income tax rate and the capital gains tax rate have been 19%. A similar flat personal income tax rate - 19% - is enacted for small business owners.

VALUE-ADDED TAX

*In alignment with EU standards
and directives*

In Poland VAT rates range from a basic rate of 22% to specific rates of 3% for non-agricultural products and 0% for books. The VAT regulations (in force from 1 May 2004 and amended in June 2005) generally reflect the guidelines provided by EU regulations, in particular the VI Directive of 17 May 1977 on the harmonisation of the laws of the member states relating to turnover taxes. Compared to the previously binding VAT legislation, the new VAT Law introduced a new definition of the activities subject to VAT (particularly with regard to marketing and advertising activities, intra-community supply and acquisition of goods), rules determining the place of supply with respect to a number of services, registration as an EU-VAT taxpayer, as well as additional documentation requirements.



BINDING RULING CONCEPTS

*An official confirmation of
tax dues*

Nevertheless, the Polish VAT law has still not been fully harmonised with the EU regulations, and some amendments to the VAT law still have to be made. Accession to the EU also resulted in an increase in the VAT rate (due to obligatory standardisation) with regard to building materials, children's wear and leisure services among others. These changes were a factor behind the price growth affecting the consumer market, especially in the DIY sector.

From the beginning of 2005, taxpayers may obtain binding rulings from tax offices confirming the tax consequences of any transaction. Applying the tax treatment confirmed in the binding ruling protects a taxpayer against potential sanctions and penalty interest.

Moreover, as of September 2005, taxpayers may apply to the Ministry of Finance (being the competent authority) for a binding ruling regarding the interpretation of tax treaties.

Additionally, as of 1 January 2006, the possibility of obtaining an Advance Pricing Agreement (APA) was introduced in the Polish tax legislation. An APA issued by the Ministry of Finance is used to confirm, in a binding manner, the correctness of a particular method of determining the pricing in transactions between related entities.

IMPORTS

Only concerns non-EU countries

Since Polish accession to the European Union in May 2004, imports are limited to countries from outside the EU as the community itself constitutes a customs union with common regulations on foreign trade (Community Customs Code and Community Customs Tariff). The trade transactions between Poland and other EU countries are treated as intra-community transactions and regulated by the EU law.

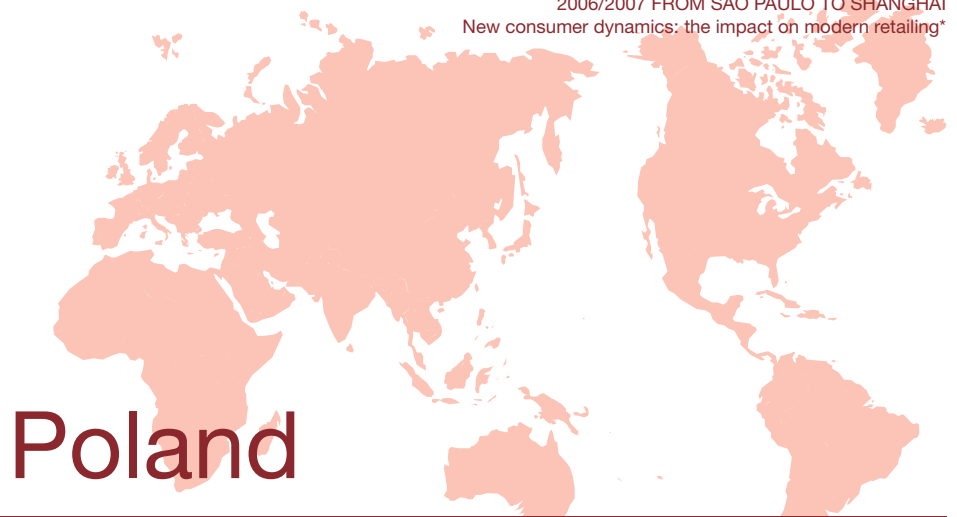
The recent year brought some important changes to the customs regime applicable in the community. In particular, the new General System of Preferences (GSP) entered into force on 1 January 2006. It comprises a general arrangement which grants products from 179 GSP beneficiary countries and territories a duty-free access to the EU market or a substantial duty reduction. It incorporates 300 additional products, mainly in the agriculture and fishery sectors in comparison to the previous system.



Poland

Another significant change concerns imports from the United States. The restrictions on imports provided in the Council Regulation from 8 December 2003 have been suspended as of 29 May 2006. Thus, the goods listed in the above-mentioned regulation, from a range of agricultural goods, textiles, industrial products, electronic products, paper products and steel, can be now imported to the EU without sanctions.

Additionally, the draft of the Modernised Customs Code (MCC) was published. This European Commission proposal aims to simplify present legislation and streamline customs processes and procedures currently applied through the EU. The MCC will provide a radical reform of customs import and export procedures, reducing their number and making it easier to keep track of goods. The result should be to increase the competitiveness of companies doing business in Europe and reduce compliance cost. The draft of the MCC is currently the subject of a public debate and it is expected to enter into force on 1 January 2009.



Poland

POPULATION EVOLUTION

A maturing demographic

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

An ageing consumer base but with an increasingly prosperous profile

Population

	2002	2003	2004	2005
Population (m)	38.2	38.2	38.1	38.1

Source: EIU, July 2006

The population of Poland has been declining since 1999. This is mainly due to the decline in the birth rate which has been observed since 2002. According to recent demographic studies, this process has not yet finished and will affect subsequent generations of Poles to a greater and greater extent.

POPULATION BY AGE GROUP

Age profile

% of total population	1999	2004	2009 (f)
0 – 14 years	19.8	17.1	15.8
15 – 64 years	68.2	70.0	71.1
Over 65 years	12.1	12.9	13.1

Source: EIU, July 2006

The result of the ongoing demographic changes is the rapid decrease in the number of children under the age of 15, who currently represent approximately 17% of the Polish population, compared with almost 25% in 1990.

At the same time it is predicted that the decrease in the mortality rate in Polish society will continue, and therefore life expectancy will lengthen from the current 74.5 years (males 70.4, females 78.8) to 77.8 years in 2015 (males 74.6, females 81.2). The present prognosis concerning Poland's population shows that the average age will rise up to 45 years in 2030, with a tendency to increase further.



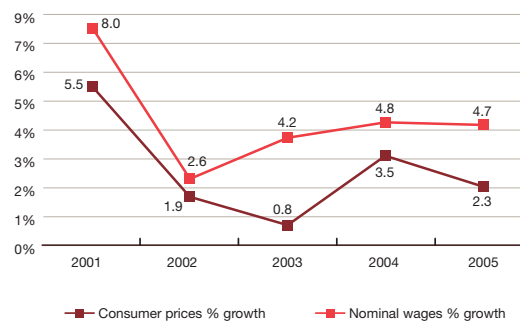
Poland

INCOME/BUYING POWER

*Increasing purchasing power
but unequal distribution*

URBANISATION OF THE POPULATION

Growth of consumer prices and nominal wages



The nominal wage rise was slightly lower in 2005 than in the previous year, but given the decrease in the growth of -1.2 points in consumer prices, the purchasing power of Polish consumers increased overall (2005).

Source: GUS – Główny Urząd Statystyczny

Urban/Rural split

% of total population	1999	2004	2009 (f)
Urban	62.2	62.6	62.6
Rural	37.8	37.4	37.4

Source: EUU, July 2006

The overall growth in the purchasing power does not apply equally to all Polish consumers. A significant difference in wealth can be observed within regions. The purchasing power of consumers living in rich areas is three times greater than that of those living in poorer ones. The highest purchasing power is to be found in large cities and the neighbouring areas, and the lowest is to be found in small towns and villages. The number of wealthy cities, where citizens can buy 25% more goods than the average Polish consumer, is 23 times smaller than the number of poorer ones, where citizens can only afford 75% less than the national average.

The changing structure of household expenditure in recent years also shows that Polish society is becoming wealthier. The average spending on food and clothing is decreasing systematically – in 2000, this amounted to almost 40% of all household expenditure, whereas in 2004 it amounted to only 34%.



Poland

A good indicator of the increasing wealth of society is the number of household appliances and radio and televisions sets, computers and mobiles phones per household. According to research, in 2004, just over 2% of households did not have a TV set and only 1.7% did not have a refrigerator. At the same time, every third household had a computer – an increase of 23.2%, compared with 2003.

Household consumption

% of HHs earning p.a.	1995	2000	2005	2010 (f)
> USD 1,000	100.0	100.0	100.0	100.0
> USD 3,000	87.1	93.8	100.0	100.0
> USD 5,000	62.3	77.6	93.9	100.0
> USD 10,000	15.3	30.4	68.0	84.5

Source: EIU, July 2006

The trend observed in recent years shows that Poles are buying more and more electric and electronic household appliances and their needs are still not fully satisfied. This situation, combined with the fact that Polish society is becoming increasingly wealthy, enables the Polish market to be determined as being a very attractive one for many manufacturers.

Average monthly gross wages and salaries

	2001	2002	2003	2004	2005	2001 – 2005 (%)
Gross in PLN	2,062	2,098	2,201	2,439	2,509	21.7

Source: GUS – Główny Urząd Statystyczny

Real personal disposable income

	2002	2003	2004	2005
Real personal disposable income (% change p.a.)	-1.9	3.3	2.4	4.5

Source : EIU, July 2006



Poland

CONSUMER BEHAVIOUR

Slow evolution in spending habits

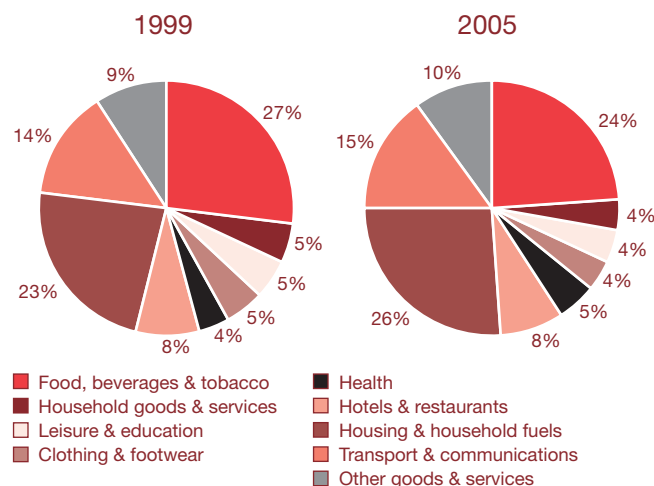
Consumer expenditure

	2003	2004	2005
Consumer expenditure: total (USD m)	139,674	159,696	187,627
Consumer expenditure (% change p.a.)	7.3	14.3	17.5

Source : EIU, July 2006

The average household spending pattern seems to have remained relatively stable within the space of the recent years. Food and drinks still constitute almost 30% of the entire household budget and expenditure connected with rent and electricity constitute a further 21%. A slight increase can, however, be observed in transport and communication expenses as well as healthcare.

Composition of average household expenditure: 1999 vs 2005

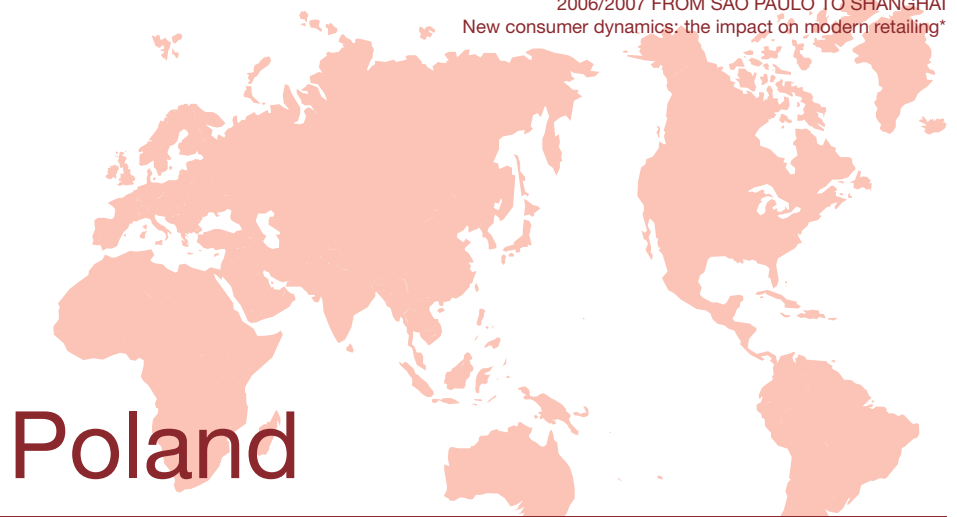


Source: EIU, July 2006

LIFESTYLES/ SHOPPING HABITS

Increasingly westernised lifestyle patterns

According to the latest research, the number of consumers of a pensionable age and so-called singles is increasing sharply among societies in Western Europe. This trend is also becoming more visible in Poland together with the decrease in the average size of households. It is estimated that by 2010, 20% of Polish society will be of pensionable age and as many as 28% will constitute one-person households. This change in the structure of Polish society will definitely have an impact on the Poles' "typical" basket of bought goods.



*Growing demand for
ready-to-eat goods*

Together with changing habits and a faster pace of living, the number of people wishing to spend their free time shopping for utilities and cooking is decreasing. The demand for convenience products is increasing. Almost every grocery shop – whether it is a traditional shop or a modern retail channel – offers pre-cooked or frozen dishes to its customers. The choice of these products is still not very wide and is represented first and foremost by traditional Polish cuisine, consisting of farinaceous dishes and modern ones such as pizzas, lasagnas or tarts; it is clear that the market for “ready-to-cook” products has a vast potential for growth in Poland.

*A new market for
health-oriented products*

Another emerging segment in the Polish retail market perspective is bio/organic food. The trend towards an ecological lifestyle is fairly recent and seems to be gaining in popularity among the growing middle classes. According to recent research, in 2005 every third Pole claims to be buying organic products. The poll also shows that approximately 20% of Polish consumers pay particular attention to buying healthy food and are very conscious of the quality of the ingredients. This trend is mostly observed in big cities, among young, well-educated consumers who are aware of the impact that healthy eating habits have on their lives. In Poland, there are approximately 200 traditional (e.g. Green Way chains) and about 20 online shops specialising in ecological food and also most of the hypermarkets and supermarkets are offering a wider range of such products. However, compared with the “old” EU countries, where shops offer a choice of 2,000 up to 3,000 organic food products, the offer in Polish outlets consists of around 200 to 300 items and is still in the development phase.

*Modern retail formats are
expected to grow*

As for shopping habits, research shows that Poles are still very loyal to the traditional grocery outlets – little ‘corner’ shops in their neighbourhood. Although the share in this retail channel has decreased slightly in recent years, it still has a very strong position among Polish consumers. 34% of recent survey respondents declared that they shop in traditional shops while 35% declare that they preferred to do their shopping in the hypermarkets. It is expected, however, that the modern retail channels in Poland will develop steadily, especially taking into consideration the biggest weapon of these large format shops. Lower prices are still one of the most important factors when Polish customers go shopping.



Poland

Brand value and product patriotism

While Poles are very price-oriented, according to the latest research, other factors are starting to play a big role for Polish consumers. With the increase in the number of so-called middle class, features such as high quality or brand recognition are becoming more and more important. Confidence in a “good” retail channel brand or the high quality of service offered in the shop is also starting to have a big impact on the choice of shopping location. Along with these trends, “product patriotism” can also be observed among Polish customers, which indicates the growing wealth of society. As recent market research shows, almost two-thirds of consumers tend to choose goods manufactured in Poland. This relates particularly to grocery products, medicines and cosmetics.

Convenience retail formats are gaining popularity

Other important factors such as convenient opening hours, good location (close to the place of residence and work) and a small floor space indicate an increasing need for convenience retail channels in Poland. So far there is only one representative of this channel in the Polish market – the abka chain – with over 1,600 outlets throughout the country, located mostly in the vicinity of households, open every day from 7 a.m. until 11 p.m., where customers can also pay their bills, develop photographs and purchase Lotto lottery coupons.

BRAND/PRICE SENSITIVITY

Greater awareness and value for brands

According to the results of a recent survey, Polish people believe that branded goods are of a better quality, availability and are safer. They also perceive branded products as being more expensive, but on the other hand, the high price is compensated by the return option in case the goods bought do not meet customer expectations.

The number of Polish customers buying their favourite brands regardless of the price is still small. In 2005 only 3% of Poles declared they would do so, compare with 9% in Lithuania and 4% in the Czech Republic.

The results of another survey show that one-third of Polish customers pay special attention to the product’s country of origin. In Poland, the percentage of customers choosing goods produced in their own home country is greater than in Germany, the Czech Republic or Hungary (in this aspect, Polish customers are only left behind by their French counterparts). This trend in customer preferences reflects the growing wealth of Polish society. It also confirms that price is no longer the crucial factor when taking shopping decisions.



Poland

Poles encouraged by the Fast Moving Consumer Goods industry are year by year becoming more aware of branded and “trendy” products with a higher quality.

The brands perceived by Polish customers to be stylish, innovative, original, authentic and exceptional are the following: Apple (Macintosh), Absolut, Google, Converse, DIESEL, National Geographic, PUMA, Body Shop, adidas and TVN24 (the winners of the CoolBrand title in the first CoolBrands 2006 competition).

Another competition, the “SuperBrands”, is organised to reward brands that have achieved a strong position in the segment and therefore provide their customers with a sense of advantage over competitors. Among the 10 SuperBrands in 2006 are: Coca-Cola, Nokia, Mercedes-Benz, E. Wedel, Microsoft, BMW, ywiec, McDonald’s, Dr Irena Eris and Pepsi. In total, 267 brands were awarded the SuperBrand title. 71 of these were Polish domestic brands.

The brands which most enjoy the trust of the Polish customer are the following: Colgate, Era, Herbapol, Hortex, Kamis, L’Oréal, NIVEA, E. Wedel, Winiary and Visa. These are also the winners in the European Trusted Brands Survey – the biggest consumer survey in Europe.

In Poland, the most brand-sensitive products are toothpaste, chocolate and coffee. Five of the most recognisable brands have won 80% of the toothpaste market, 78% of the chocolate market and 72% of the coffee market.

Private Labels

A nascent segment with a delicate balance between price and quality

The share of goods sold by supermarkets under their private labels amounts to only 4% of their total sales. It is less than twice the average in the Czech Republic, Slovakia and Hungary.

Goods sold under private label are perceived as being cheap products of low quality. Only 35% of Polish customers believe that they can be compared to branded products in terms of quality. In Germany and the Netherlands, this percentage is 82%. The global average is 62%.

Private labels are widely accepted in the case of hygienic products, washing powders, juices and teas. The lowest level of acceptance is for wine, non-prescribed drugs, cosmetics and children’s nutrition products.

In Poland, private labels are on average half the price of branded products. The difference is the biggest when comparing the prices of tea, toothpaste, shampoo and soda drinks and the smallest in the case of milk, diapers and pet food.



Poland

*Few medium level
own-labels*

This differential is mainly due to the fact that there were hardly any medium- and premium-quality private label products in Poland. Lately, the large retail networks have been working on their medium-priced brands and trying to improve the quality of the low-priced brands. Five retailers own private labels, Tesco, Kaufland, Hypermart, E.Leclerc and Carrefour, that have launched a medium-priced brand. Makro also offers a medium-quality brand.

The leaders like Tesco and Carrefour do take premium brands into account as far as their private label range of products are concerned. These are goods of a high quality, specialised and often niche. In Great Britain, Tesco runs five specialised lines of products. In Poland it will probably begin with organic foods and snacks.

For the time being, even private label brands that are of a higher quality are still 20-30% cheaper than branded products. However, more and more retailers are beginning to realise that their image is strongly affected by their private labels. As a result, the range of private label products is growing and the quality of manufacture is put under stringent control. More attention is being paid to the aesthetic design of packaging and the image of the private label, which is being created using sophisticated marketing techniques.

Evolving target perceptions

The latter is related strongly to the evolution of private label product placement. Until recently, elderly, poorly educated people with low earnings were believed to be the target group. Now, the largest retailers are not only trying to change the image of their private labels, but also focusing on a wider range of customers. The introduction of premium private labels on a larger scale in Poland is believed to be a long-term strategy.



Poland

MAJOR CONSUMER GOODS PLAYERS

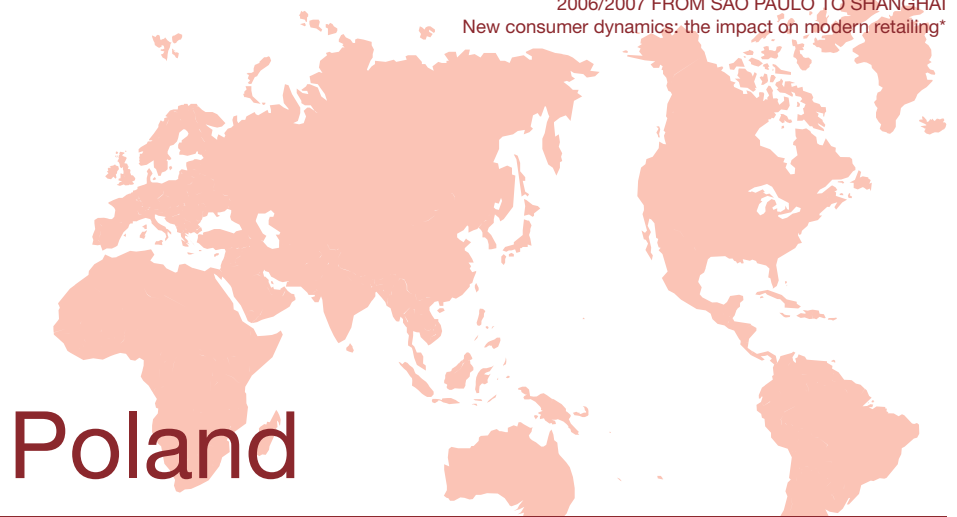
Established presence of international companies

RETAIL AND CONSUMER SECTOR PERFORMANCE

A strong year with increasing competition from Polish players

The Top 20 list is occupied mainly by multinational consumer goods players. The ranking reflects also consolidation activities, which occurred on the domestic market in the last two years (for example, the Central European Distribution Corporation or Grupa Maspex Wadowice).

No.	Company Name	Category of products	2005 Net Sales (EUR mn)
1	Philip Morris Polska	Tobacco	1,400
2	Kompania Piwowarska	Brewery	740
3	LG Electronics	Electronic	728
4	Grupa Żywiec S.A.	Brewery	712
5	Thomson Multimedia Polska	Electronic	690
6	Philips Lighting Poland	Electronic	667
7	Procter & Gamble Operations Polska	Food/Chemicals/Cosmetics	637
8	Central European Distribution Corporation	Alcoholic beverages	604
9	British American Tobacco Polska	Tobacco	566
10	Nokia Poland	Electronic	547
11	Grupa Animex	Meat products	522
12	Unilever Polska	Food/Chemicals/Cosmetics brand management	497
13	Imperial Tobacco Polska S.A.	Tobacco	485
14	Sobieski Dystrybucja	Alcoholic beverages	464
15	Scandinavian Tobacco	Tobacco	457
16	BSH Sprzęt Gospodarstwa Domowego	Household equipment	456



Poland

Food and beverages
A good year for Polish producers

*Rapid growth for
non-alcoholic drinks*

17	Grupa Maspex Wadowice	Beverages	447
18	Krajowa Spolka Cukrowa	Sugar	440
19	Avon Operations Polska	Cosmetics	424
20	Nestlé Polska	Food & beverages	390

Source: company data

Following Poland's accession to the EU, the restrictions in agricultural trade have been eliminated and the domestic food industry has continued its fast growth trend started in 2004. It is estimated that food exports reached EUR6.5 billion in 2005 (a 25% increase year-on-year), which is particularly impressive given the disadvantageous PLN/EUR exchange rates. Neighbouring countries value Polish products (in particular dairy products, vegetables, fruit and beef) because of their good quality and competitive prices. Diligent pre-accession preparations and the continued maintenance of high investments have helped create quality products and now, due to benefits of the Common Agricultural Policy, the future of Polish producers looks very promising.

In 2005, dairy exports grew by 50% to about EUR924 million, mainly due to high prices on the world market. Most Polish exports were channelled to the EU market. However, the year's success was spoilt by the European Commission's decision to fine dairy producers for exceeding the milk quota for the year 2005. High dispersion of the industry remains a problem and will eventually lead to consolidation.

The economic conditions were also favourable for the Polish meat producers. EU accession contributed to price increases and the decrease in the price of wheat caused a cost reduction. However, at the end of 2005, breeders were hit by the Russian Agricultural Ministry's decision to introduce a ban on the import of Polish meat which, last year, was worth USD520 million. Poultry producers on the other hand faced a decrease in the consumption of poultry due to the worldwide paranoia about bird flu spreading into Poland.

The non-alcoholic drinks industry has been developing dynamically, with the production of bottled water, soft drinks and fruit juices increasing by 35% since 2000. The soft drinks sector is dominated by global players, Coca-Cola and PepsiCo. However the Polish producer, Hoop, is gradually increasing its market share, which was almost 12% at the end of 2005. Coca-Cola also controls almost 7% of the water segment, but is still behind Nestlé with



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8% and the Danone Group with 28% of market share (with its Polish brand Zywiec Zdroj). The fruit juice industry is dominated on the other hand by Polish companies: Maspex, Agros Nova and Hortex. Together, they sell over 50% of the products in this category.

2005 will be remembered as the year of consolidation in the Polish liquor industry. Central European Distribution Corporation, the number one distributor of liquors in Poland, bought two leading producers of vodka. Bols was bought from its French owners, while Polmos Bialystok was bought from the State Treasury. After the purchases, CEDC's market share has reached around 30%, dethroning the previous leader, Belvedere Group, which controls around 27% of the market.

Following a few years of fast growth, the annual beer consumption in Poland neared 80 litres per capita last year, close to the European average. 30 million hectolitres were brewed, which is 5% more than in 2004. Polish lifestyles are changing and physical activity and mobility are gaining in importance. Poles now often prefer to drink beer rather than stronger alcohol such as vodka thus increasing market demand and encouraging the entry of new brands on the market.

The brewing industry is controlled by three leading producers, owned by global breweries, accounting for over 85% of the market share. Exports have started to gain a gradually increasing role in the industry.

Creating new product segments

Kompania Piwowarska, part of the SABMiller Group and the leading brewer in Poland, has started to sell the first light type beer in Poland, giving birth to a totally new category on the beer market. Beer with reduced alcohol and caloric content was first distributed in June 2006.

Launch of the new beer category – LITE – is a response to the growing, global trend frequently referred to as “health and beauty”. The new beer’s alcohol content has been reduced to 3.8% vol. Another distinctive feature is 25% fewer calories as compared with regular beer.

Lech Lite will be available in bottles of 0.66, 0.5 and 0.33 as well as in cans. LITE has been very preferably rated in a qualitative consumer research. The consumers believe that the new beer will allow them to overcome the sensation of “heaviness”. The brand is particularly popular amongst active consumers who consider themselves modern and declare the importance of well-being and an active lifestyle. Lech Lite is the second variant of the Lech brand only recently launched to the market by Kompania Piwowarska.



Poland

Electronics *Increasing wealth, higher demand*

It follows the launch of Lech Free – alcohol-free beer. At present the alcohol-free beer segment is not large yet its importance will increase as consumers' attitudes change, following an active lifestyle, including frequent travelling. The product contains less than 0.5% alcohol and is distinguished by its pleasant taste compared to other similar products.

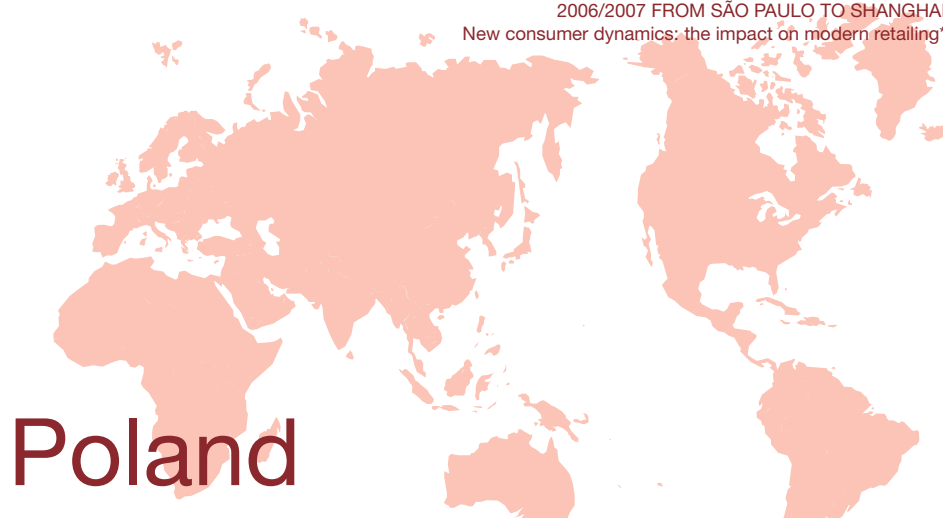
It is expected that between 2005 and 2009, sales of television sets will grow by 10%, washing machines by 23% and refrigerators by 17%. Producers are hoping that Poles will want to have more modern equipment in their houses, as currently the average age of used refrigerators is 10 and 8 for washing machines. Furthermore, only one in four Poles owns a microwave oven and only one in 14 households own a dishwasher.

TV sets are the most common equipment in most Polish households. Poles are currently shifting from traditional TV sets to LCD and Plasma ones. In 2005, there was an almost fourfold increase in the sales of LCD sets with the most popular brands being Samsung, LG and Philips.

Sales of DVD players in Poland exceeded 500,000 per year in 2005. Global companies such as Philips, Panasonic and Thompson have the highest market share, but it is also worth taking note of the rapid increase in sales of so-called low-end trademarks, created especially for hypermarket chains.

The digital camera market experienced a boom in 2005. Almost one million pieces of digital equipment were sold. Traditional producers such as Canon, Nikon, and Olympus have captured almost 60% of the market and it is very likely that they will benefit from its future growth.

As predicted, competition in electronic retailing has become very fierce since the British electronic appliance retail chain, Dixons, opened its first two outlets in Poland. With a total of seven to eight stores planned to be opened in major Polish cities, Dixons may pose a threat to the current leaders, such as Media Markt and RTV Euro AGD. After entering the Warsaw market, the British giant claimed that its entrance led to a 20% decrease in prices.



MAJOR RETAIL PLAYERS

Domestic players are making their presence felt

Retail sales

Expanding modern retail channels

Retail sales

	2003	2004	2005
Retail sales (USD m)	103,205	118,616	109,394
Retail sales growth (% p.a. in PLN)	3.6	2.5	-20.1
Retail sales: food (USD m)	52,602	60,119	55,194
Retail sales: non-food (USD m)	50,603	58,497	54,200

Source: EIU, July 2006

As expected, modern retail channels are continuing their growth in Poland. According to recent market research, the number of modern format shops rose by 560 in 2005, which constitutes a growth of 22% compared with the previous year. Contrary to some earlier predictions, traditional shops in Poland still have a stable share in the entire retail market of approximately 50%. This situation results from the fact that Poles are still used to traditional shops, located mostly in the vicinity of their homes and there continues to be a lack of modern format retail outlets in small towns with a population of less than 50,000.

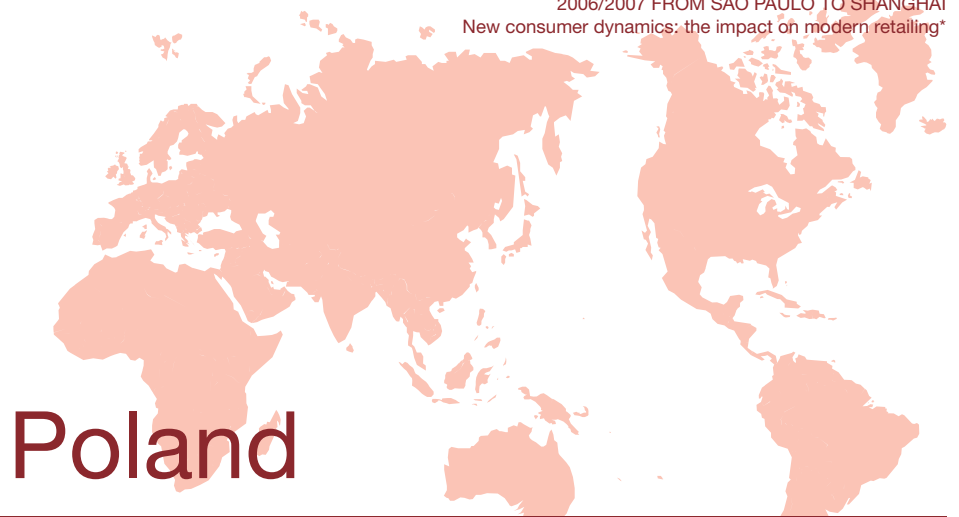
In the near future, it is predicted that the development of modern retail channels will be much faster than that of the traditional ones. This will, however, take place in a form quite different from that observed in the past 10 to 15 years. The main change will relate to a decrease in the average floor space and, therefore, in the growing number of newly-opened supermarkets and convenience stores. This situation is mainly the result of the low urbanisation rate in Poland, since more than 60% of the population lives in small towns and villages, where there is no demand for hypermarket formats. According to the recently revealed plans of most of the retail players on the Polish market, it can be expected that the number of outlets with an area of up to 1,000 square metres will soon increase. Tesco, for example, is about to open approximately 20 such stores out of the 39 new outlets planned in 2006. These plans seem to be confirmed by the very recent purchase of the Leader Price chain from the Casino Group. Polish retail chains are also willing to extend their existing store network. Eldorado, for example, opened 13 new outlets in 2005 and expects the same growth in the following year.



Poland

Major retailers

Rank	Group name	Store Brands	Retail formats	Number of stores 2005	2005 net sales (EUR m)
1	METRO Group	Makro C&C Real	Cash and carry Hypermarkets	22 30	3,043
		Saturn, Media Markt	Household appliances	31	
2	Jeronimo Martins	Biedronka	Discount stores	805	1,348
3	Tesco Polska	Tesco Savia	Hypermarkets Supermarkets	49 56	1,329
4	Carrefour Polska	Carrefour Champion	Hypermarkets Supermarkets	32 71	1,127
5	Auchan Polska	Auchan Elea	Hypermarkets Supermarkets	19 14	985 (e)
6	RUCH	RUCH	Kiosks	>11,000	981
7	Casino Group	Géant Leader Price	Hypermarkets Discount stores	18 206	842
8	Lewiatan Holding	Lewiatan	Supermarkets/ Convenience stores	1,618	820
9	Ahold Polska	Hypernova Albert	Hypermarkets Supermarkets	13 170	760 (e)
10	Schwarz Group	Kaufland Lidl	Hypermarkets Discount stores	77 150	758 (e)
11	REWE	Selgros Minimal	Cash and carry Supermarkets	9 27	565 (e)
12	MILO S.A.	Milo	Wholesaler	14	679
13	Kolporter	Kolporter	Convenience stores/Kiosks	1,000	586
14	Tengelmann	Plus Discount OBI	Discount stores DIY	161 25	618
15	BOS Group	BOS	Wholesaler/ Cash & carry	9	591



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16	Avans	Avans	Home appliances	600	493
		Avans Mega	Home appliances	0	
17	Musketeers Group	Intermarché	Supermarkets	111	487
		Bricomarché	DIY stores	37	(e)
18	E.Leclerc	E.Leclerc	Hypermarkets	16	447
			Supermarkets		(e)
19	Eurocash	ABC	Cash and carry	94	419
20	Castorama	Castorama	DIY	30	410

Source: Companies' financial statements, Rzeczpospolita – Lista 500, Polityka – Lista 500, Trade Press – Supermarket)

(e): Estimate

Retail formats

Need to be developed to be consistent with Polish needs

Hypermarkets
Suited to larger metropolitan areas

Breakdown by number of stores

Year	Hypermarkets	Supermarkets	Discount stores	Convenience stores (traditional channels)
2003	202	924	1,274	115,800
2004	240	960	1,357	115,300
2005	263	1,270	1,466	115,000

Source: GfK Polonia, PricewaterhouseCoopers estimates

The number of hypermarkets in Poland is still growing; however, it is doing so at a slower pace than in previous years. In 2005, there were some 260 hypermarkets, compared to 240 in 2004. Most of the global players are present on the Polish market, Tesco and Real (after each acquired parts of Casino network) being the market leaders.



Poland

As most of the metropolitan areas – the natural habitat of hypermarkets – are significantly saturated, retailers are now looking at smaller formats. There has been a rapid growth of supermarket-size outlets operated by Carrefour (Carrefour Express) and Tesco.

Talent development strategies

Tesco is the biggest UK investor in Poland, entering the market in 1995 and now operating over 100 stores including 50 hypermarkets. Tesco has created 20,000 new jobs with each hypermarket employing 500 people and each supermarket employing 40 to 100 people depending on the size. 40% of these employees were previously unemployed and Tesco co-operates effectively with local authorities to create long-term, stable jobs.

The rapid growth of Tesco in Poland has created many development and career opportunities. Whilst the ownership is from UK, the management is very much Polish and there are a maximum five expatriates in the business, based mainly in project roles. All the hypermarket directors are Polish and the company has invested in core skill training and UK secondments to ensure that the pipeline of talent is sufficient to meet the demands of the ambitious opening programme.

11% of the employees are graduates for whom Tesco is their first Company. Tesco offers a structured programme of technical, management and leadership training to support these managers through the rapid development required.

The success of Tesco Polska in talent planning has caught the attention of other parts of the Tesco Group and there are now Polish managers who learnt their skills in Tesco Polska working in Tesco operations in China, Czech Republic and UK.

Supermarkets
*Well-established domestic
segment*

Supermarkets, next to discount stores, are the most promising, yet competitive retail segment in Poland. With retailers moving to mid- and small-size towns, this format can better meet local customers' needs whilst offering a broad range of products.



Poland

Discount stores
*Increasingly popular in a
price-conscious society*

Much of the market is franchise-operated, for example, Intermarché, Lewiatan or Piotr i Paweł. Contrary to hypermarkets, Polish investors play an important role here. The key local chains include POLOmarket, Eldorado (Stokrotka) and Lewiatan, which are strongly opposing the foreign competitors, represented by Tesco (Savia), Carrefour (Champion/Globi) and Ahold (Albert).

Apart from large networks, many local or regional operators exist throughout the country, taking advantage of the smaller capital requirements and more liberal regulations concerning opening stores with a floor space of less than 2,000 square metres.

Among the modern retail formats, a significant increase has, in particular, been observed in the number of newly opened discount stores. In 2005, there were approximately 1,500 such outlets all over Poland, representing a rise of 25% compared with 2004. The best examples of such intensified development are the Lidl and Biedronka chains. Last year, Lidl opened approximately 120 new discount stores, while Biedronka (so far the biggest discount chain in the Polish market) opened 80 new stores and currently operates a total of 805 such outlets.

Discount stores, having found their niche in the smaller cities (below 50,000 inhabitants) and rural areas, are still expected to develop quickly, as this market is still far from being saturated. The latter has lured the German chain operator, Aldi, to enter the Polish market, whose first outlets are to open in 2007.

Developing discount store formats to answer consumer needs

Jeronimo Martins Dystrybucja owns the Biedronka discount retail chain that has been present in Poland since 1995. Biedronka is the biggest food retailer in Poland, operating more than 840 stores and five major distribution centres and employing more than 13,000 employees.

The mission of Biedronka is to offer a limited assortment of high-quality and carefully selected products, satisfying the needs of its consumers according to the concept of "Everyday Low Price". Biedronka is positioned as a cash discount, defining a strategy of simplification and low complexity in its business processes. This allows the achievement of operational excellence and cost efficiencies to be reinvested into price competitiveness.



Poland

Simultaneously, the trends in consumer behaviour strongly determine Biedronka operations. In a typical retail experience, consumers tend to the variety of many products, brands, changing prices and arrangements.

Biedronka has been adapted to offer a completely different shopping experience:

- Operating with an assortment of little more than 800 essential products in order to enable a faster and smoother shopping experience.
- Offering a carefully selected range of products, Biedronka privileges innovation and quality rather than variation, through its exclusive label, perishables offers and special non-food product opportunities.
- Consumers do not need to be concerned with price changes and deal with temporary promotions, thanks to permanently stable, low, fair and binding prices.
- More “homey” and stable store layout with a constant range and uniform look.

Biedronka aims to open around 100 stores per year so that convenience and proximity complement the best shopping experience.

This strategy of permanent adjustment to consumer behaviour assures the fidelity of its consumers, confirmed by the more than one million daily visits to Biedronka stores.

Cash & carry
Dominated by international players

The Polish cash and carry market is still dominated by Makro Cash & Carry, operated by the German METRO Group. Polish companies are fighting back mainly through consolidation. A recent example is the merger between BOS Group (which has already been through local consolidations in previous years) and Eldorado.

Convenience stores
A consumer-preferred popular format

With some 115,000 outlets, convenience/grocery shops are playing a major role in the Polish retail market. Poles prefer to buy groceries at local shops, thus giving the traditional retailers a spacious niche in which to operate and good prospects for the future.



Poland

Do-It-Yourself *Potential for further development*

One of the fastest developing branches in the retail sector are the so-called Do-It-Yourself Stores (DIY). In 2005 there were two reasons for this development:

- It was the last year to utilise/deduct the so-called “construction allowance” from income tax.
- The development of large DIY chains.

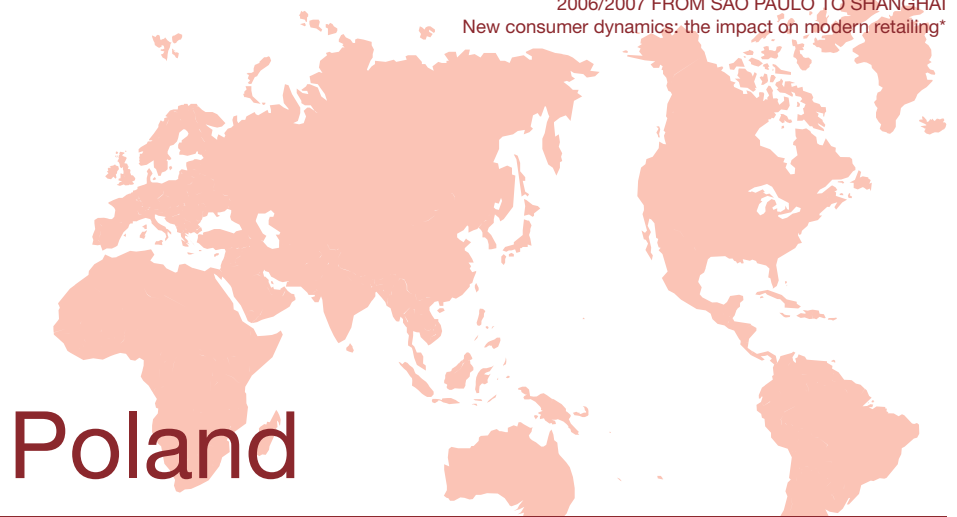
The development of the DIY chains resulted both from acquiring the turnover of smaller shops and expansion of the market. Chains like this started to develop in Poland much later than the regular retail chains, but their development translated into lower prices and, therefore, the less wealthy customers could finally afford to buy construction materials to renovate their houses.

Together with the development of this part of the retail sector, there was one issue that resulted in the total turnover being lower than in the previous year. This was the increase in the rate of VAT for construction materials, from 7% to 22% in May 2004. Customers rushed to the shops in spring 2004, the outcome of which was record sales in 2004. Since no such events took place in 2005 – apart from the termination of the construction allowance – the total turnover dropped.

Currently, the DIY market is still dominated by small shops which have a total of 44.9% of the market share. According to GUS, the total number has increased in the last five years from 15,000 to 19,000, but these numbers are taken from the REGON register, which contains many companies which no longer exist. The actual number is closer to 9,000.

Short characteristics of some chosen companies:

- **Polskie Składy Budowlane (PSB):** this is a buyers' organisation of wholesalers of building materials which was set up to create a central buying, marketing and training policy in order to reduce the costs of the particular members of the group.
- **Castorama:** In Poland, Castorama opened 30 DIY hypermarkets and is planning to introduce another brand, the Brico Depot (a chain of smaller DIY supermarkets), in the near future.
- **OBI:** The first polish DIY supermarket was opened in 1998. At present it owns 25 outlets in Poland (there are over 500 globally). The company operates mainly as a franchise.



Poland

Textile retailing
*A promising segment for
modern retail formats*

*Domestic retailers expand
operations*

- **Grupa Handlo-Budowa:** this is similar to PSB, the Handlo-Budowa Group is a buyers' organisation, which is owned by 113 wholesalers of building materials (it also provides services to 287 other independent wholesalers). Apart from acting as buyer on behalf of the members of the group, it also sells its own products (mainly simple construction materials).
- **Praktiker:** The first Polish DIY-hypermarket was opened in 1997. At present, it owns 17 shops in Poland.

Currently the value of the apparel market in Poland is estimated at between USD6 billion and USD7 billion and it still has a very big potential for growth. In 2005, sales of clothes increased by 20% from USD4,863 billion to USD5,835 billion and it is expected that by the end of 2010, the segment will be worth over USD8 billion.

The retail sale of clothes in Poland has a similar structure to the retail sale of food since almost 40% of all sales are conducted via independently-owned, traditional shops. It is expected, however, that the market share of such outlets is likely to fall by up to 20-25% in the long term especially in favour of large, well-organised, mostly manufacturer-owned chains such as Reserved (LPP), Tatum (KAN), H&M, Zara or Troll (Redan). It is also worth mentioning that hypermarkets and supermarkets have their stake in the Polish clothing market. This channel mainly attracts customers through the low prices and frequent promotions and accounts for 15% of all clothing sales in Poland.

Almost all the big clothing chains operating on the Polish market are planning on continuing their growth in 2006 – via organic growth, mergers or acquisitions, going public. NFI Empik Media & Fashion with its clothing subsidiaries – Ultimate Fashion, Galeria Centrum and Smyk – opened 49 new stores in 2005 and aims to open more than 50 additional outlets in 2006. The Polish clothing distributor KAN (Tatum brand), currently operates 34 stores in Poland and abroad, is also planning to increase the number of its outlets to 60 by 2007. Two of the famous elegant clothes producers in Poland, Wólcanka and Próchnik (both of them listed) announced their merger in June this year. This will allow them to strengthen their position on the market and expand their activity more dynamically both in Poland and abroad. Another well-known elegant clothing producer, Próchnik, opened its first shop in the Ukraine and is planning to spend over PLN7 million on further expansion in the Ukraine.



Poland

E-commerce
An accepted retail channel

and Russia. Last year, the Polish retailer, Monnari Trade, opened 38 shops and wants to widen its chain with a further 20 outlets in 2006. Monnari Trade is additionally planning to enter the Warsaw Stock Exchange. The Polish shoe retailer, Gino Rossi, went public by entering the WSE in July 2006.

It is worth mentioning that many Polish clothing companies are not only developing their chains in Poland but also abroad. The best example is LPP with its brand names Reserved and Cropp. The company already owns more than 30 stores in neighbouring countries (including thirteen in the Czech Republic, eight in Estonia and five in Latvia) and is currently planning on expanding into Russia and the Ukraine with as many as seven and 10 new outlets respectively to be opened within the next few years.

Mobile subscribers and Internet users

	2005
Mobile subscribers	29,244,000
Internet users	7,439,800

Source : EIU, July 2006

E-commerce in Poland had a very good year. The turnover of internet shops and auction portals reached PLN3.1 billion, which means that it exceeded 1% of total retail sales for the first time. Users of auction sites sold goods worth PLN1.8 billion, while e-shops sold goods and services worth PLN1.3 billion. Polish auction portals are different from their Western Europe or American counterparts, as most of the transactions are conducted without any bidding. The fast-growing e-commerce has lured the world biggest auction site, eBay, which opened its Polish subsidiary in 2005. According to experts, the most important growth factors for the development of e-commerce are the increasing number of e-shops (800 to 1,000 depending on the source) and the growing availability of credit cards.

Domestic Internet travel agencies are multiplying their revenues every year. Although they currently control only approximately 2% of the market, they look to the future with optimism. The largest – travelplanet.pl – made a successful public offer and is now quoted on the Warsaw Stock Exchange.

The typical Polish online buyer is male (72.9%) and young (44% of the customers are below the age 24), with above-average earnings. The fast growth of e-commerce allowed Poland to pass Italy and Spain in respect of the ratio of online buyers among Internet users (in 2005, the percentage of Internet users declaring themselves to be online buyers increased from 44% to 55%).



Poland

E-commerce : maintaining competitiveness

Allegro.pl is the biggest auction portal in Poland. In 2005, it celebrated its sixth birthday. It started off as a hobby both for its founders and the first users. Nowadays, it is a professional business employing over 100 people. For many users, it has become the main place where they earn their living. Allegro conducts over one million auctions a day. Each day, there are more than 5,000 new-user registrations.

The total figure of sales via Internet in Poland in 2005 was PLN3.1 billion. The auctions accounted for PLN1.8 billion. Allegro itself generated PLN1.5 billion of this amount. It is worth mentioning that in the years 2002 to 2005, the site's turnover increased tenfold. These results have given Allegro an almost monopolistic position among auction portals in Poland and a 50% share in the Polish e-commerce market.

In 2005 the world's largest auction site, eBay, opened a Polish subsidiary. Although eBay was long expected in Poland, its entrance did not significantly affect the market as Allegro is acutely aware of competitors and remains alert. In 2005, it launched its first advertisement campaign, having previously relied on word of mouth. The new campaign, with its "See you" slogan, is aimed at attracting new users to the site and increasing Allegro brand visibility within Polish society. The Allegro site also enjoys cult status with a small Internet community and registers the greatest number of visits per month – 2.12 billion, outpacing similar players such as Google and Onet. Allegro's users, which numbers close to four million, communicate with each other and exchange opinions on discussion forums, have their families' picture galleries and twice a year meet in the real world to consult about the techniques used in e-commerce.



Poland

CHALLENGES

Further market
consolidation

RETAIL AND CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

Over the last few years, Poland has witnessed many takeovers and mergers in the retail and consumer sector, but latest events prove that consolidation in the sector has well and truly taken root.

The number of large retailers operating on the Polish market makes it something of a phenomenon in Europe. By PricewaterhouseCoopers estimates, by 2010, the largest players will drop from the current approximation of 20 to five to six as a result of mergers and acquisitions, as has been the case in Western Europe.

The most interesting element in the process of market consolidation is the fact that, besides large foreign operators, Polish networks, which are also subject to consolidation, are growing in strength and are beginning to successfully compete with the giants. Acquisitions are the natural way to expand for the former, whereas for the latter they constitute a certain guarantee against takeover attempts by foreign networks.

One of the fastest-growing Polish networks, POLOmarket, the operator of approximately 160 shops, is taking over 17 supermarkets of another Polish network, ABC. A listed group Eldorado, operating in south-eastern Poland, owning supermarkets and a network of warehouses as well as 500 franchised shops, is in the process of merging with the BOS Group, which conducts wholesale and retail sales in north-western Poland. The consolidated group will own eight retail networks. The total turnover, including the wholesale, is to reach approximately PLN3.8 billion. According to the announcements made by the chairmen of the two groups, this is only the beginning of a series of takeovers. In June this year, Społem disclosed its consolidation plans. It intends to merge 4,000 units presently operating under the name Społem and managed by regional co-operatives. If the consolidation is a success, Społem may outpace many foreign operators operating on the Polish market in a few years' time.

METRO AG of Germany has taken over a part of the business activities of the French Casino Group for EUR224 million and expanded its activities in the Polish market. The transaction comprises 19 existing Géant shops and seven further locations either planned or already under construction. Following this acquisition, Real will own 49 hypermarkets, with total sales of EUR1.3 billion. By the end of 2008, the group intends to own 58 operating units. Tesco has acquired a network of Leader Price shops from the French Casino for EUR105 million. The Portuguese company, Jeronimo Martins, one of the biggest retail



Poland

operators in Poland, has announced the further development of its Polish discounts chain, Biedronka. One of the ways of fulfilling this aim is to take advantage of the progressive consolidation of the retail sector. If another chain is in line with Biedronka's development strategy, Jeronimo Martins will try to take it over and at the same time will continue opening new outlets.

Consolidation activities on the Polish market are not only driven by competition, but may also be determined by politicians, who are planning to impose legal restrictions on the construction of large-format supermarkets.

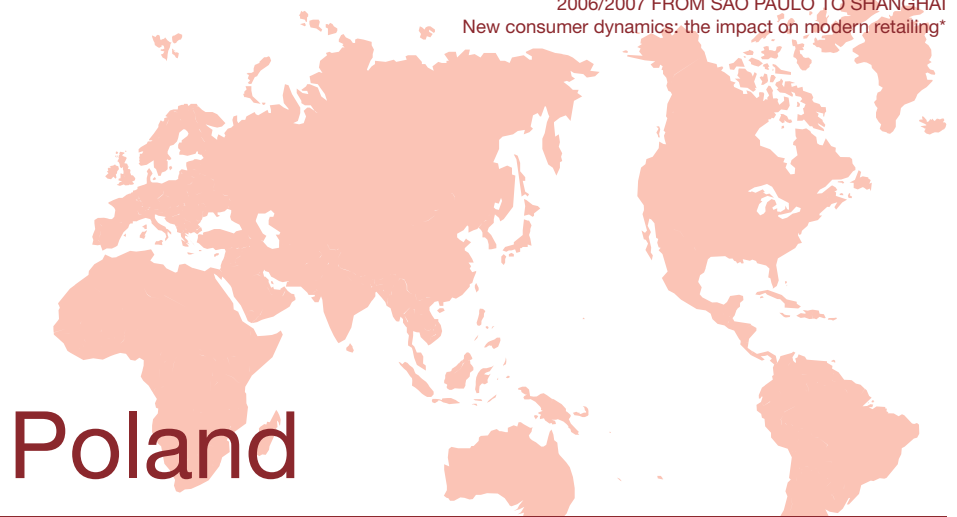
Acquisition as a growth strategy

METRO AG began operating on the Polish market in the mid-90s. At present, 83 retail units operate under the brands Makro Cash&Carry, Real, Media Markt and Saturn in Poland. Today, METRO Group continues to strengthen its position on the Polish market by making further investments.

By the end of 2006, it will open two new electronic supermarkets in Poland under the brand name Saturn. In 2007, it intends to open 10 more outlets, five under the brand name Media Markt and five under the brand name Saturn. The strength of Real, on the other hand, will increase as a result of METRO taking over the Polish network of Géant supermarkets from the French Casino Group.

METRO Group has only taken over the operating activities of Géant, without purchasing any real estate. As a result of the acquisition, one in three hypermarkets in Poland will operate under the brand name Real, with the total number of units under that brand name growing to 49. It is estimated that after the merger, Real Polska will employ more than 13,000 people and its sales may reach EUR1.3 billion.

According to Dr. Hans-Joachim Körber, the CEO of METRO Group, the takeover of Géant supermarkets is an element in the company's expansive development strategy. The transaction is aimed at increasing the value of METRO Group in Poland, as well as globally.



Challenges in domestic market concentration

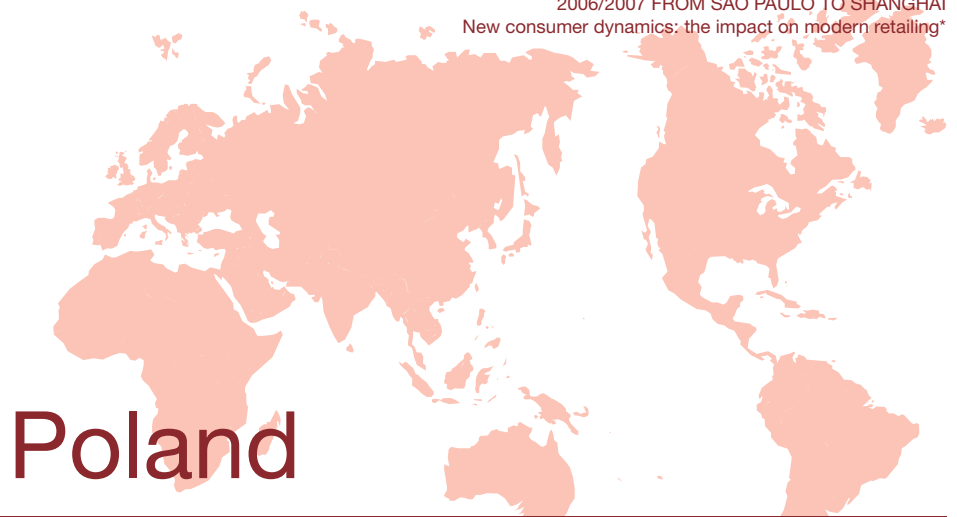
Spółem is the oldest Polish retail co-operative, which used to operate a huge number of convenience stores before it was split up in 1990. Unfortunately, it did not manage to comply with the new market rules which came into being after communism collapsed in Poland in 1990. The co-operative was divided into many smaller groups, most of which are managed regionally.

Currently, there are about 120,000 members, associated in 400 Spółem co-operatives in Poland. Spółem owns more than 4,000 outlets of 725,000 square metres spread evenly across the country, located mainly in city centres or on housing estates. In 2005, the group's turnover amounted to PLN7.1 billion, which is the second highest in Poland after the METRO Group (PLN11.7 billion) and better than Jeronimo Martins Dystrybucja (PLN5.37 billion.). Spółem is a Polish trade organisation with a long tradition and vast experience with a group of loyal customers.

In June 2006, Spółem announced its plans to re-consolidate the existing stores under one trade mark, "Spółem". The first 900 will be consolidated in the countrywide network by autumn 2006, and it is believed that a further 600 will join in 2007 and the remaining Spółem outlets within the following two to three years. Central distribution and co-ordination will be lead by Krajowa Agencja Handlowa (National Trade Agency, NTA). The latter will also be responsible for logistics, a common price policy, the marketing strategy and the launch of an integrated computer system. The outlets are supposed to have a uniform interior design and offer a similar range of products.

The problem is that the Spółem co-operatives are highly independent which make it difficult to unify them into a uniform commercial network. As far as the overall standards are concerned, the individual outlets differ significantly from one another. Moreover, not all the co-operatives are willing to merge. The stronger the co-operative the more reluctant it becomes to forgo its independence. Some co-operatives agreed that only some of their outlets will join the network. Others, like Spółem Białystok, which owns a number of wholesale warehouses and is the leading distributor with a significant number of external customers in the whole region, can see no advantages in adjusting to the network's requirements.

The transformation of the highly differentiated Spółem outlets into a cohesive network with a centralised distribution system is extremely complicated and requires much time and many resources. That is why the merger of Spółem, as well as developing a new image for the trademark has been divided into several steps that will take a few years to complete.



Polish supermarkets grow in strength

Last year's events prove that Polish traders are capable of successfully competing against foreign large-format chains in the supermarket sector. Domestic traders have now outpaced foreign retailers. The number of Polish supermarkets increased by as much as 54% in the past year. This mainly results from the improving financial position of domestic firms and the consolidation of small trade. As at the end of 2005, there were almost 1,300 supermarkets in Poland, half of which belong to Polish firms. In the past few years, they have opened more outlets than their foreign rivals, although the difference has never been this big.

Polish owners have successfully found their niche in the evolving market, filling the gap between hypermarkets and traditional shops. Hypermarkets have slowed down their expansion, because the market in big cities is saturated with this form of trade and opening such units in smaller towns does not pay off. Consolidation, usually carried out through joining one of the domestic chains, is one of the ways of strengthening the position of Polish supermarkets.

The next two years should bring about yet another increase in the number of domestic supermarkets. One of the largest chains, POLOmarket, owning 152 retail units, intends to double that number within three years. The listed Eldorado, the owner of Stokrotka supermarkets, plans to open at least 13 new retail units this year, increasing its total number to 68. The listed Alma will almost double the number of its Alma Markets from five to nine this year. The Piotr i Paweł chain, on the other hand, presently owning 29 supermarkets, is planning to open two new retail units by the end of December.

Therefore, supermarkets have become the right vehicle for developing Polish chains.

Restrictions on retail trading on Sundays

The Polish ruling coalition has started a legislative process related to the restriction of Sunday trading. The proposed regulations are to prohibit trading on Sundays in all stores except for small grocery outlets owned by micro-entrepreneurs. The new law is highly likely to come into force in the near future, which may have a significant impact on the financial performance of a number of retailers.



Poland

Corporate Social Responsibility is gaining importance

Corporate Social Responsibility (CSR) constitutes an integral part of EU economic policy. The objective of running a company in accordance with these principles is strongest in the “old EU” states, where it is a result of a company’s internal policy, and where it is supported by legal regulations and expectations raised by consumer organisations. The idea of corporate responsibility spreads from here; holdings pass it on to their subsidiaries around the world in the form of a corporate culture, and it is also a growing global trend.

The CSR idea is clearly present in Poland, in particular in the retail and consumer sector, where foreign corporations that have been gathering awards for good business practices for last few years are now facing “competition” from a growing number of companies with Polish capital and culture. One can expect that sooner or later, the principles of corporate responsibility will trickle down to smaller firms.

What has become a global trend in the sector – moving beyond the initial CSR practices of managing reputation risk, presentation of engagement in social and charitable work to a strategic approach to CSR issues in order to gain a competitive edge in the marketplace – is still in the early stages of development in Poland. Most probably, we shall see Polish entrepreneurs in this sector following the same trend.

In Poland, the following multinational companies have been active in promoting corporate responsibility: Avon, British American Tobacco Polska (BAT), Cadbury Wedel, Danone Polska, Nestlé Polska, Philip Morris and Procter & Gamble. Among retail chains known for their good practices in Poland are METRO Group and Tesco. Dom Towarowy Bracia Jabłkowscy, Dr Irena Eris, Żywiec Group, Grycan – lody od pokolen, Kompania Piwowarska and others are among Polish firms promoting corporate responsibility.

All the aforesaid firms have established good practices in areas where business mixes with the workplace, marketplace and community.

A report prepared by the European Commission gives the example of Dr Irena Eris as a firm providing a friendly workplace, which has opened its own training and development centre for employees, contractors and clients. The firm also provides extra financing for its employees’ further education. As part of its employee healthcare programme, the company has opened a clinic on its premises, where employees can receive flu vaccinations and other health services sponsored by the employer.



Poland

Within the community category, Procter & Gamble and Fundacja Polsat have been organising the “Give Children Some Sunshine” campaign since 1999. It consists of donating part of the revenues from the sales of P&G products towards the purchase of specialist medical equipment to save the lives of children and young people (e.g. early cancer diagnostics) and educational initiatives addressed to doctors.

In the field of marketplace, the firm Dom Towarowy Bracia Jabłkowscy sponsored the “Jabłkowski Brothers Fair Trade Award”. This is awarded to a family business from Warsaw that has traditional values, observes the work ethic and which, in the eyes of its clients, deserves the award.

These are just a few examples to be mentioned, but the number of good practices in this sector both in multinational as well as local companies in Poland will be growing. And we wish all of them will be able to demonstrate strategic thinking in the CSR approach in the future. We can see the first evidence already – the trend is right, it is worth continuing.

OPPORTUNITIES BPO/Offshoring

The growing popularity of off shoring seems to indicate a great opportunity for investors in Poland. It is estimated that by 2008 the global market for BPO will amount to USD100 billion. In 2005 Poland was ranked fifth among the best places for locating BPO centres. According to the survey, Poland’s main advantages are: low labour costs, a skilled workforce and stable economic situation after accession to the EU. The large interest of foreign investors in locating their Shared Service Centres in Poland has already translated into a certain amount of action. In 2005 Shell, Ahold Central Europe and the American computer services provider Affiliated Computer Services decided to establish their financial and business processes centres in Krakow. At the beginning of 2006 the financial centre of Philip Morris International also began its operations in Krakow. Other companies that have also recently opened their Shared Service Centres in Poland are: Hewlett-Packard (Wrocław), Philips (Łódź), General Electric (Łódź), Cap Gemini (Krakow), IBM (Krakow), Thomson (Warsaw), Lufthansa (Krakow), Volvo (Wrocław) and Unilever (Krakow).

E-commerce booming

Within the next four years, the total value of purchases made via the Internet in Poland should increase by 300%. Such a significant increase is mainly due to the fact that demand for permanent access to the Internet has still not been saturated (on average, 50% of the EU inhabitants – compared to only 30% of Poles – have permanent access to the internet) which is related to its relatively



Poland

Development of smaller forms of retail

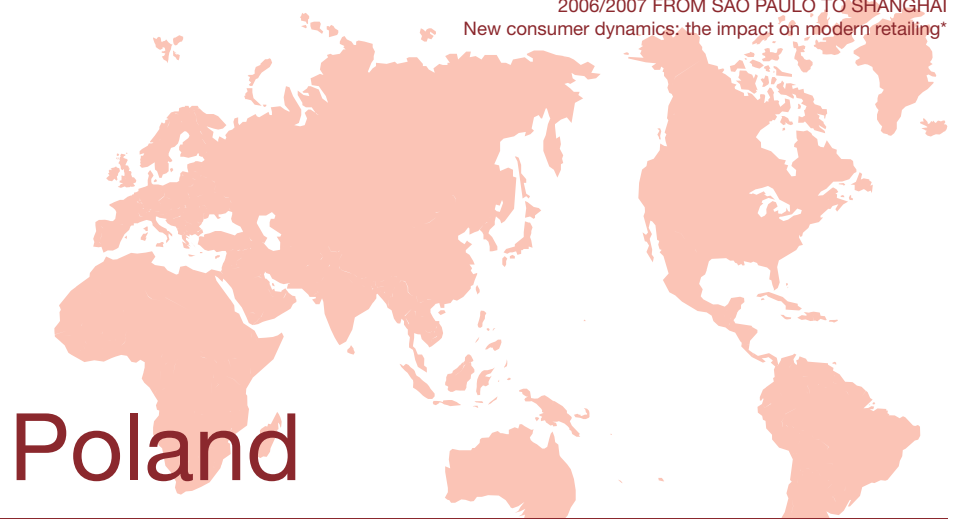
high cost. Additionally, Internet sales should be enhanced by the opening of broadband access to the Internet, further expenditure on developing and advertising home delivery sales via the Internet and a simultaneous decrease in the number of postal sales. As a result, the share of e-commerce in the total of retail sales will exceed 4% and enable Poland to move ahead of countries such as Sweden and Holland. More and more Internet users are doing their shopping via the Internet. Virtual shopping malls, independent outlets and niche Internet services have entered the e-commerce market. It is possible that in the future they will acquire customers who are, nowadays, devoted to the Internet auctions. Sales of easily transferable goods such as food are conquering the Internet. Companies which have launched an attack in this area are: Piotr i Paweł, E.Leclerc and BOMI.

Together with the development of large retail outlets in Poland, a new group of consumers has emerged, which, over the last 15 years, has been transformed from indiscriminating shoppers standing in gigantic queues and shopping mainly in street markets into demanding customers, aware of their rights and more often than not looking for high-quality goods and services. The contemporary Polish customer may not buy much, but he shops very often. The Poles do not like to spend much time wandering around a hypermarket, which they usually visit once a week. Overall, the Poles spend more than 50% of their money in local shops.

Not all Western supermarket chains are able to keep up with the changing tastes and needs of the new Polish consumer. The quality of the goods and services offered by hypermarkets is still far from satisfactory. Therefore, today's more informed consumers, who have gained some experience of large retail outlets and have more money than they did few years ago, are beginning to look for smaller retail outlets which offer better quality products, qualified and friendly service, good location.

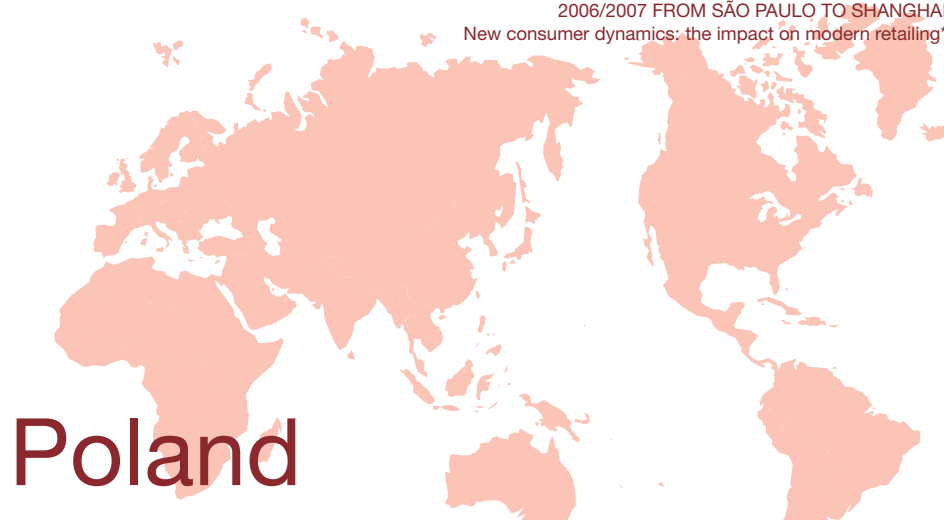
This is why the chains that watch the market closely and are able to react promptly to its changes are already modifying their strategy and starting to open smaller shops. They want to benefit from the fact that the Poles are used to quick shopping near their homes. Apart from low prices, the customers' choice is driven by the convenient location of a shop (near home or work), well-organised space, a wide offering and good service.

Therefore, in June 2006, the French chain Carrefour opened its first Polish Carrefour Express (a new type of supermarket) in Ostróda. The new Carrefour Express shops will differ from Champion and Globi supermarkets; their retail space will be organised differently and their offering will be bigger. The British



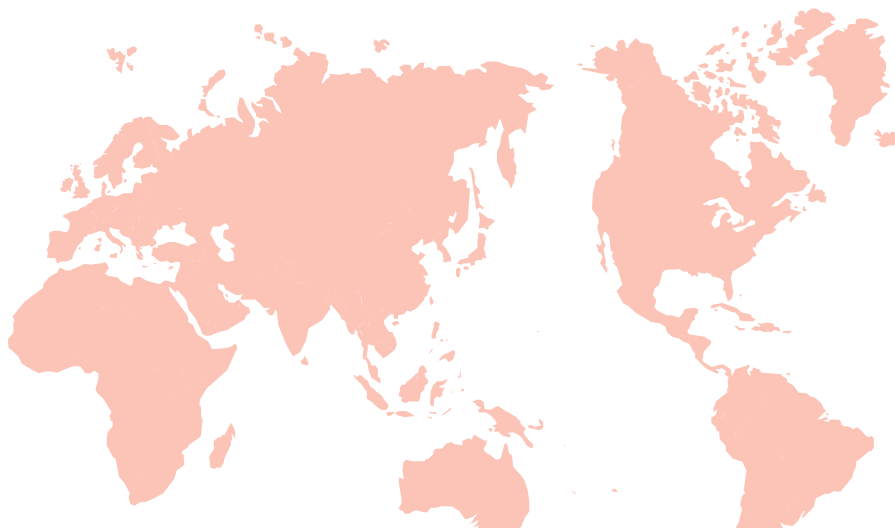
Tesco Group has started to develop smaller shops as well. First it started to open supermarkets with an area of up to 2,000 square metres. Recently, it has introduced outlets named “Jedynka” with an area of up to 1,000 square metres. To date, the company has opened seven such shops. Now, having completed the pilot stage, it has announced its intention to develop a network of such shops in Poland quickly. By the end of March 2007, 20 to 30 Tesco outlets with an area of 1,000 square metres each will operate in Poland. It is also possible that the group will subsequently bring to Poland the Tesco Express chain, which is already present in other countries. Biedronka, the discount chain, has also quickly adapted to the new market conditions by investing in better-quality products and new fixtures and fittings.

The domestic Polish retail chains are also reacting to the new trends. The Społem chain has renovated most of its outlets and extended the range of goods offered at attractive prices. Some other Polish chains, for example, Lewiatan or BOMI, have also invested in local shops. There are also some new brands, such as Winniczek or Chata Polska. They sell products made according to traditional recipes, and their attractive decor makes the customer want to revisit the shop.



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Russia



Area ('000 sq km)¹: 17,075
(US 9,600 – EU25 3,981 – World 133,700)

Capital²: Moscow
(Number of inhabitants: 14 million)

Population (million): 143
(US 296 – EU25 459 – World 6,000)

Median age³: 38 years

Nominal GDP (USD billion): 763.6
(US 12,487 – EU25 13,447 – World 44,183)

Nominal GDP (USD billion at PPP): 1,552.2
(US 12,487 – EU25 12,657 – World 59,763)

GDP per head (USD at PPP): 10,822.9
(US 42,129 – EU25 27,538 – World 9,962)

Currency³: Russian Rouble (RUR)
(USD1 = RUR28.3)

Languages³: Russian

Main religions³: Russian Orthodox, Muslim

Government type³: Federal Republic

Sources: () Economic Intelligence Unit 2006 data,
(¹) World Bank 2005, (²) City Population,
(³) CIA Fact book



ECONOMIC OVERVIEW

A highly contrasted market, Russia is characterised by features of both mature and transitional economies

GDP AND CPI

Promising GDP growth

Inflation remains high

Despite a small lag in 2005, economic growth in recent years has generally been on the upswing. With a GDP growth of 7.2% and over in 2003 and 2004, figures have exceeded those for 2002 of 4.7%. In 2005 GDP growth was at 6.4%, slightly lower than in 2003 and 2004. After a slight fall from the end of 2004 until mid-2005, growth regained strength, fuelled by high oil prices, increase in personal incomes and household consumption.

Inflation remained at an annual rate close to 12% and exceeded the 10.9% forecast of the Ministry of Economic Development and Trade of the Russian Federation. The reasons for these were:

- Significant increase in utilities rates triggered by changes in the mode of payment and transfer of households to a 100% payment for utilities.
- Increase in food prices

GDP and CPI

	2002	2003	2004	2005
GDP growth (%)	4.7	7.3	7.2	6.4
CPI (%)	15.8	13.7	10.9	12.7

Source: EIU, July 2006

UNEMPLOYMENT

Nationally differentiated labour market

Russia's well-educated labour force is an important asset for long-term growth. Its lower-cost and generally highly skilled workers are an important asset for investors. However, competition amongst the retailers and Fast Moving Consumer Goods (FMCG) companies is forcing wages up, low labour costs are therefore not the primary reason behind the current increase in activities.



Russia

In large cities, such as Moscow, St. Petersburg and Nizhniy Novgorod, the labour market can be compared to those of developed countries, with a strong dependence on unskilled foreign workers to fill in low-paid jobs. In these regions unemployment levels are the lowest. Simultaneously, outside large towns the labour situation is similar to that seen in developing countries where in some regions unemployment significantly exceeds the average national figure.

The economically active population in Russia constitutes 66.3% of the total population. Over five million (5.2) people were unemployed in 2005 (Source – Goskomstat). Unemployment decreased from 8.6% in 2003 to 7.6% in 2005.

Unemployment

	2002	2003	2004	2005
Unemployment rate (%)	8.1	8.6	8.2	7.6

Source: EIU, July 2006

ECONOMIC FORECAST

Maintaining momentum

Strong outlook

The government needs to continue making economic reforms if it is to achieve President Putin's declared objective of doubling GDP by the end of the decade. This includes maintaining the confidence of domestic and foreign investors, and integrating Russia further into the world economy by joining the WTO, which, the Russian authorities hope may take place during 2008.

Macroeconomic fundamentals will remain strong, especially as oil prices are expected to remain at high levels. Market opportunities will be good, despite some slowdown in growth. WTO accession should increase Russia's attractiveness for foreign investors, as will the liberalisation of the capital account. Russia's retail and consumer market is likely to sustain a wave of joint ventures with foreign investors.

Key economic forecasts

	2006	2007	2008
GDP growth (%)	6.0	5.7	5.0
CPI (%)	9.8	9.2	8.1
Unemployment rate (%)	6.7	6.6	6.4

Source: EIU, July 2006



FOREIGN DIRECT INVESTMENT

Retail attracts large portion of FDI

REGULATORY ENVIRONMENT

An attractive market albeit with administrative barriers

Traditionally the bulk of foreign investments in Russia are directed to the retail and wholesale trade sectors (32% in January-September 2005) followed by manufacturing (28%) and mineral resources sectors (17%).

The largest investors in Russia are European countries (around 80% of foreign investments in 2005). Cyprus, Luxembourg and the Netherlands are leaders in terms of total accumulated foreign investment. However, a large part of this foreign investment can be qualified as reinvestment from Russian companies through foreign based holding companies. According to Central Bank's statistics in 2005, Russia attracted USD13.1 billion or 1.7% of GDP.

FDI

	2002	2003	2004	2005
FDI (RUR bn)	108.5	244.3	445.0	412.9
FDI (USD bn)	3.5	8.0	15.5	14.6

Source: EIU, July 2006

According to a survey conducted by the Economic Intelligence Unit (EIU) in May 2005 Russia is at the top of the list for high growth markets in Eastern Europe for 2005 to 2007. More than 80% of foreign companies in Russia (mainly in consumer goods, IT and the auto sector) reported more than 10% sales growth. 50% of companies had profits growing over 20% and 15% saw profits growth over 50%. 80% of Western companies have continued expansion plans in Russia for the next 2 years.

At the same time, several factors are impeding the flow of foreign investment. These include administrative barriers, a high level of corruption within the authorities and the legal system, political risks and an underdeveloped infrastructure.



Russia

LAND/REAL ESTATE OWNERSHIP

No restrictions of real estate ownership by foreigners

CORPORATE INCOME TAX

Set at 24%

VALUE-ADDED TAX

Fixed at a standard rate of 18%

Although the vital role played by foreign direct investment within the country's economy has been officially recognised, Russia has not provided significant nationwide incentives for FDI. It is however permanently improving overall business conditions by reducing the tax burdens and administrative pressures which affect both national and foreign companies. Regional governments are also authorised to establish additional incentives for foreign direct investors, including reduced regional tax rates or tax relief in regard to regional components of the tax rates, and some other incentives.

Stable economic growth, rapid development of the consumer market and high profit margins of FMCG companies are making Russia attractive for foreign direct investment.

The land code of the Russian Federation does not contain any restrictions on foreign ownership of land plots that may affect retail businesses. Non-agricultural land plots for construction purposes may be leased or purchased under general competitive conditions.

However, foreign ownership of agricultural land plots and, therefore, direct ownership of agricultural land plots by foreigners, or by Russian legal entities with foreign share of over 50%, is prohibited. Such entities are limited to leasing agricultural land plots for a period of up to 49 years.

In general, bureaucratic procedures can make it hard to obtain all the necessary permits required to obtain access to land. Another issue is the lack of transparency in the process of assigning land plots for rent. Action is being taken to make the process more transparent.

There are no barriers to purchasing and owning buildings and premises for foreigners or Russian companies with a foreign investor. No stamp duty is levied on the purchase of immovable property in the Russian Federation.

The regional authorities have the right to reduce the tax rate by 4% within the qualified share of their budget (up to 17.5%). No other tax rebates apply.

Some basic food products, goods for children, periodical press and some medical goods are taxed at 10%.

Special 0% rates are applicable to exports and technological equipment imports. Some activities are also exempt from VAT (e.g. insurance and banking



Russia

UNIFIED SOCIAL TAX (UST)

Levied at 26% of payroll for every employee

SIMPLIFIED TAX SYSTEM FOR SMALL/MEDIUM COMPANIES

Substitutes profit tax, VAT and property tax

CUSTOMS CODE

Reformed in compliance with WTO requirements

TRANSFER PRICING

Tax bodies may intervene in certain transactions

operations). The lease of premises is exempt from VAT for foreign citizens and organisations which have official approval from the Russian Federation. Under some conditions foreign organisations and representative offices may also be freed from VAT when executing commercial activity.

Currently every company is obliged to pay UST for every person it employs. Resident companies of special economic zones benefit from tax privileges and are obliged to pay UST of 14% of the payroll.

Small or medium companies meeting certain criteria can choose an alternative "simplified tax system". The tax rates are 6% of the gross sales or 15% of the profit. Moreover, small businesses (Russian companies only) are exempt from paying VAT if their turnover does not exceed 15 million RUR (USD559,658) per annum and they do not employ more than 30–100 employees (depending on the area of activity).

The new customs code came into force on January 1, 2004.

The average applied import tariff for Russia is 10.4% for industrial goods and 21% for agricultural goods. Earlier reforms in 2001 consolidated Russian tariffs into basic categories and lowered some tariff rates to combat customs fraud and improve collections.

Taking into account VAT applied to all imports the final amount of total taxes paid can reach 40% (although, strictly speaking, Russian VAT of 18% should be recoverable). This practice makes it difficult for legitimate importers to maintain price competitiveness.

There are signs that steps are being taken by the government to reduce illegal imports, notably a new law approved on May 11, 2006 under which the Federal Custom Service is under direct control of the government.

Since January 1, 1999, tax bodies are authorised to control the prices applied in related party transactions, foreign trade transactions and transactions in which prices fluctuate by more than 20% within a short period of time. The price used in such controlled transactions may be adjusted for tax purposes only if it differs from the market price by more than 20%.



Russia

ADVERTISING LAW

New and stricter regulation of advertising mediums

There are a number of initiatives which significantly amend the transfer pricing rules and introduce transfer pricing documentation requirements.

A new law 'Of Advertising' of March 13, 2006 came into force on June 1, 2006. The previous law of July 18, 1995 was out of date and did not stipulate regulations for some advertising activities that were non-existent in 1995 (e.g. advertising via mobile phones).

The main amendments in the new law concern restriction of advertising time on TV and radio (reduced by more than half), permission for advertising of strong alcohol drinks at points of sale and in some printed media, introduction of more strict rules on advertising of consumer credit, limitation of gambling business and TV shop advertising, limitation of mass mailing of advertising messages, prohibition of umbrella brands and outdoor advertising of some goods (e.g. tobacco products).

It is forecasted that these changes will cause redistribution of advertising budgets from TV advertising to printed media and greater direct support in the HORECA sector (Hotel, Restaurants and Cafes). A general rise in prices for advertising (around 180-190% according to estimations) is also expected which will affect local middle and small enterprises which will not be able to afford TV and outdoor advertising.

OPENING HOURS

Few limitations for retailers

It is a usual practice that retailers operate 24 hours, seven days a week as they have the right to set opening hours themselves. According to the Russian Labour Code, employers are obliged to compensate employees for the non-standard working time-table.



Russia

DEMOGRAPHICS AND CONSUMER BEHAVIOUR

The Russian consumer base is sharply divided between brand conscious high-end consumer and price-sensitive low-end consumers, providing opportunities for different retail formats.

POPULATION EVOLUTION

Fairly large and stable

The resident population of the Russian Federation as of the January 1, 2006 was 143 million people, including 53% women and 47% men.

In 2005 the annual population decreased by 0.8%. This drop is caused by a natural population decrease which was not compensated by an increase of birth rates or immigration: the death rate exceeded the birth rate by 5.9% in 2005.

Population

	2002	2003	2004	2005
Population (m)	145.2	144.5	143.9	143.4

Source: EIU, July 2006

POPULATION BY AGE GROUP

A demographic structure similar to mature economies

The decline in the resident population over the past decade has naturally led to a decrease in the 0-14 age group (15% of the total population in 2004 vs. 18.6% in 1999), which could, in turn, lead to labour shortages. In addition the population is aging and by 2050, pensioners are forecast to be 2.5 times the size of the 0-14 age group and will represent 35% of the total population. The government intends to increase birth rates through a birth incentive program increasing financial aid. More migrants are also expected to contribute to the need for a larger work-force.

Age profile

% of total population	1999	2004	2009 (f)
0 – 14 years	18.6	15.0	14.2
15 – 64 years	68.9	71.3	72.1
Over 65 years	12.5	13.7	13.7

Source: EIU, July 2006



Russia

URBANISATION OF THE POPULATION

Sharply contrasted settlement patterns

Most of the population of Russia is concentrated in the western part of the country, west of the Ural mountains. The urban share of population constituted 73% in 2005 including 13 cities with over 1 million inhabitants (Moscow, St. Petersburg, Chelyabinsk, Ekaterinburg, Kazan, Nizhny Novgorod, Novosibirsk, Omsk, Perm, Rostov-on-Don, Samara, Ufa and Volgograd).

Urban/Rural split

% of total population	1999	2004	2009 (f)
Urban	72.9	73.1	73.5
Rural	27.1	26.9	26.5

Source: EIU, July 2006

INCOME/BUYING POWER

Uneven income distribution

Annual average income, expenditure and savings rate per capita

Annual average	2003	2004	2005	2004–2005 Growth (%)
Income (EUR)	1,774	2,128	2,673	25% ¹
Expenditure (as % to income)	79.4	81.3	82	+0.7
Savings (as % to income)	20.6	18.6	18	-0.6

Source: Rosstat

In 2005, 14.3% of the population had income of less than the official minimum subsistence level of EUR 86.82/month which is slightly less than in 2004 (17.8%) but is still high.

¹ Or 9% growth of the real disposable income (The real disposable income is an income adjusted according to the consumer price index, with mandatory payments deducted).



Russia

Consumer Price Index and Growth of Nominal Wages in 1998-2005

	1998	1999	2000	2001	2002	2003	2004	2005
Nominal wages, y-o-y growth (%)	10.6	47.7	43.2	45.7	34.5	26.1	22.6	36.9
Consumer Price Index, y-o-y growth (%)	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9

Source: Rosstat, Ministry for Economic Development and Trade

Nominal wages grew by 36.9% in 2005 while the consumer price index increased by 12.7%.

Improvement in the well-being of the population can be judged by the increase in the level of ownership of consumer durables. At the beginning of 2006 there were on average 176 personal cars per 1,000 inhabitants in Russia which is 3 times more than in 1990. In Moscow the penetration of personal cars is much higher and equals 253 cars per 1,000 residents. In 2005 there were 125.8 million phone numbers (SIM cards) in Russia representing a 69% increase from the previous year.

The Russian Federation is recognised as a country with a high level of disparity in incomes: 10% of the highest Russian incomes are estimated to be 30-40 times higher than poorest 10% of the population. Moreover, there is a significant variation in income and buying power between regions. The richest population is concentrated in Moscow, St. Petersburg, large regional centres and several smaller cities where enterprises of the extracting industries are located (Yamalo-Nenetski region, Sakhalin region, Murmansk region, etc).

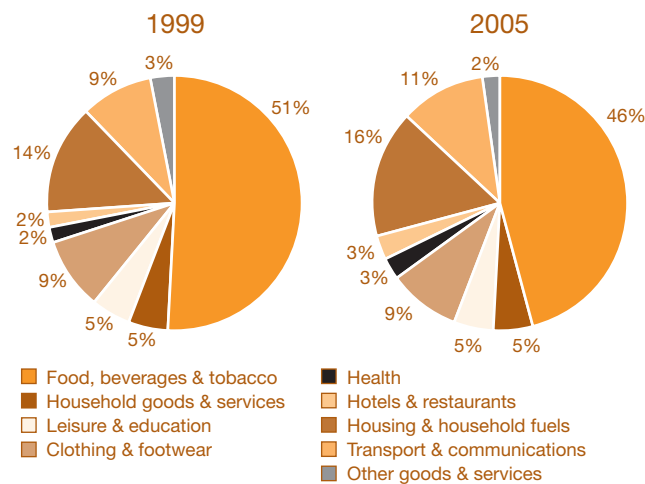


Russia

CONSUMER BEHAVIOUR

Changing consumption patterns

Composition of average household expenditure: 1999 vs. 2005



Source: EIU, July 2006

The structure of household consumption in Russia has changed significantly over the past five years: the share of income spent on foodstuffs dropped from 51% in 1999 to 46% in 2005. Food expenditure in Russia is being replaced by increased expenditure on household facilities, recreation, education and cultural services.

Non-food and service expenses are expected to grow in the structure of the consumer basket within the next 7 years. These trends are related to a growing economy and rising consumer income per capita.

LIFESTYLES/ SHOPPING HABITS

Increasing prosperity is affecting consumer aspirations

An improvement in the quality of life has changed the Russian consumers' habits which are now increasingly inspired by Western styles. This is mainly reflected in a growing attention of the consumers to comfort, extra services, and premium class goods.



Russia

Consumer preferences have also shifted towards rapid food preparation. Compared to 2001, more consumers eat out than before (36% in 2005 vs. 25% in 2004).

Since 2000, Russians have been using more banking services than in the 1990s, especially consumer loans. The share of retail sales made on credit reached 14% of retail trade in 2005. The life insurance market penetration in Russia was 0.12% in 2005 which is much higher than 0.03% in 2003. 60% of middle class representatives have a car in a household.

87% of people own their apartments, which they received as an inheritance, however many still live with their parents. The lack of living space in Russia is estimated to be 1.6 billion square meters.

Representing 37% of the population in 2005, the Russian middle class' share of total consumption of goods and services increased from 45% in 2001 to 75% in 2005².

32% of middle class representatives have a monthly gross income of USD250 to USD350, 38% – USD350 to USD500, 22% – USD500 to USD700, 6% – USD700 to USD1,000 and 2% – more than USD1,000 per capita. Only 20-40% of household expenditures fall into the food category while 15-20% is being saved (around USD1,000-3,000 a year per household). Household savings are mainly spent in the purchase of home electronics, cars, education and travel. It is predicted that almost half of the middle class representatives are going to improve their living conditions and spend up to USD33,700 within the next two years.

2 According to the results of the annual middle class survey, conducted by Expert-Data Research Agency.



Russia

RETAIL AND CONSUMER SECTOR PERFORMANCE

Rising incomes are fuelling a rapid expansion within the two sectors.

MAJOR CONSUMER GOODS PLAYERS

Key consumer goods companies

	Company name	Category of products	2004 Gross Sales (EUR m)	2005 Gross Sales (EUR m)	Origin
1	Wimm-Bill-Dann	Food	831	1,120	Russian
2	Baltika	Brewing	665	977.2	International
3	Sun Interbrew	Brewing	537	894.7	International
4	Philip Morris Izhora	Tobacco	665	N/A	International
5	United Confectionaries	Food	421	510.9	Russian
6	Coca-Cola HBC	Beverages	354	488 [†]	International
7	Mars	Food	466	N/A	International
8	APK Cherkizovski	Food	428.8	442	Russian
9	Lebedyanski	Food	307	413	Russian
10	Ochakovo	Beverages	198.8	179.4	Russian

Source: Companies information

Some significant FMCGs do not provide detailed information. For example, Pepsi Co, Kraft Foods, Unilever, Procter & Gamble.

[†]Estimates

Food and beverages
The third largest market in Europe

In 2005, food and beverages (excluding alcohol) market volume is estimated at EUR160 billion. Around 35% of the market is not counted in official statistics and consists of counterfeit and undeclared products, sold at open markets, including farmer's products.

The sector is constantly growing with a 20-25% rate in 2004/2005. Growth is primarily driven by rising real disposable income levels. It is forecast that the market may reach EUR250-350 billion by 2008-2010.



Russia

The latest tendencies in food and beverages include the growth of small regional producers, strengthening competition and changing consumer preferences towards healthy products.

The food & beverages industry in Russia is one of the most attractive industries for foreign investors. Almost all major international food companies have established their production capabilities in the country by building brand-new plants or investing money in local capacity.

Multinational giants such as Coca-Cola HBC, Mars and Heinz are acquiring new assets in Russia and investing into local production facilities.

The leading Russian companies in the sector are Wimm-Bill-Dann (dairy products and juice), APK Cherkizovsky and Tsaricino (meat products), United Confectionaries (confectionary products). International companies dominate the brewing sector with Baltic Beverages Holding, Baltika, AMBEV, Heineken and Efes.

Beer
*5th largest market after
China, USA, Germany
and Brazil*

Experts estimated the Russian beer market at EUR3.8 billion in 2005. Since 2000, the volume of beer production in Russia has increased by 1.6 times. In 2005 year-on-year (y-o-y) growth is about 8% (405.2 million litres).

In 2005, new advertising restrictions were introduced resulting in a slowdown of sector sales and consumption growth rates. In 2005, the growth rate decreased to 8% from 11% in 2004. The forecast growth rate for 2006 is around 3-4%.

The total volume of investments in the fixed capital of the Russian brewing trade is estimated to be EUR570 million in 2005 (23% of all investments in the food industry).

More than 300 beer producers operate in the country, while the 6 largest producers control about 85% of the market. In 2005, the consolidation process continued due to a number of mergers and acquisitions (e.g. Heineken acquired Pivovarni Ivana Taranova (PIT), Stepan Razin and Baikalskaya beer company, AMBEV, acquired Tinkoff, BBH acquired Yarpivo).

The list of the largest beer producers is dominated by Baltika Beverages Holding, with 36% market share. Other big players on this market are: AMBEV (18.6%), Heineken (9.2%), Efes (8.4%), Ochakovo (6.6%) and SAB Miller (6%).



Russia

Juice

*A segment registering
strong growth*

The juice market is one of the most dynamically developing segments of the Russian consumer market. In 2005 the market volume is estimated at EUR1.5 billion with y-o-y growth amounting to 14%. The market is forecast to continue growing at 12-13% rate in 2006.

The juice market in Russia is divided almost equally between four major producers: Wimm-Bill-Dann (Russian), Lebedyansky (Russian), Multon (belongs to Coca-Cola HBC) and Nidan (Russian).

Confectionary

*Fourth largest market
in the world*

The Russian confectionary market is one of the largest in the world after the UK, Germany and the USA. In 2005, the market volume is estimated at EUR6.8 billion. However the market is close to saturation and growth rates are slowing down. In 2005, the market volume growth rate was around 3-4%.

The chocolate segment is the largest segment of the confectionary market (60%) with the highest growth rate in 2005 (5.7%) when compared to other segments of the confectionary market.

The main trend of the market is the growth of premium class brand consumption (from 6.1% in 2004 to 8.4% in 2005), caused by changing consumer preferences and real income growth.

The main players of confectionary market are: Dirol Cadbury, Kraft Foods, Mars, Nestle, SladKo and United Confectionaries³.

Dairy

A nascent industry

According to the Union of Enterprises in the Dairy Industry, the Russian dairy market amounted to approximately EUR17.6 billion in 2005 with 4% annual growth rate.

The market is still at its initial creation stage. There were 1,774 dairy re-processors in Russia by the end of 2005 with 53 of them producing 50% of the dairy products.

The main players in the sector are: Danone, Ehrman and Wimm-Bill-Dann. Local players dominate in the regions where the logistics of milk collection hamper large scale operations.

A large share of the sector remains unregistered because of trade at open markets.



Russia

Electronics

*Led by foreign brands
and imports*

The Russian electronics market amounted to around EUR12 billion in 2005. The industry is largely dominated by imports.

Due to toughening customs controls in 2005 there was an increase of legally imported products.

Introduction of consumer credit in stores greatly contributed to the market development. Now up to 30% of sales in this sector are done by credit.

Since 2000, Russian production of electronics has been increasing. In 2000, Sokol opened a factory for TV set production and in 2002 a new market player called Sitronics appeared on the market. Its product range includes TV sets, DVDs, home theatres, monitors, PC and mobile phones.

Clothing and shoes

*An import oriented market with
a large "grey" segment*

The Russian clothing and footwear industry is import-oriented, with only 20-25% of goods produced in Russia. Due to a high share of grey imports market volume estimates vary from EUR 18 billion to EUR 28 billion while the sales of shoes are estimated at EUR 4-5 billion. In 2005, y-o-y growth rate of the clothing and shoes market was about 20%.

Only 15% of the clothing market represents branded high-street fashion. Most of the leading apparel brands are established in the Russian market.

The two main problems of the market are grey imports and counterfeits. About 55-60% of clothes and footwear are imported into Russia under 'grey schemes', where import values are understated to reduce duties and VAT. Along with the bulk of cheap unbranded imports coming from China, Vietnam, Korea, other South-East Asian countries and Turkey, the Russian market is filled with counterfeits of famous brands of both local and imported origin.

Despite the dominance of clothes and shoes of foreign origin the number of Russian producers is growing. The main domestic clothing and shoes market players are: Gloria Jeans, OGGI, Sela, TVOYE and Tervolina. Russian manufacturers tend to choose foreign words as brand names because consumers are more loyal to foreign clothing and trust its quality.

Cosmetics and personal care

An annual growth rate of 15%

The Russian cosmetics and personal care market is one of the most rapidly growing in the world. In 2005, the market is estimated at EUR5.6 billion demonstrating a 13% annual growth rate.



Russia

Brand reputation *Managing brand forgery*

According to expert estimates, the cosmetics and personal care potential market is of EUR12–14 billion. Due to changes in consumer preferences and growth of consumers' incomes, the most attractive segments are: luxury cosmetics, men's and children's products and anti-age cosmetics.

The market is dominated by foreign leading cosmetics companies (Beiersdorf, Colgate-Palmolive, Johnson & Johnson, L'Oréal, Procter & Gamble, Schwartzkopf & Henkel, Unilever Group). The main domestic producers are: Kalina, Nevskaya Kosmetics, Svoboda. Competition between Russian and foreign producers is strengthening.

The main countries exporting cosmetics and personal care products to Russia in 2005 were: Poland (23%), France (20%), Germany (12%) and Finland (10%).

Fraud and counterfeits are serious challenges in the Russian market. The list of counterfeit products consists mainly of alcohol, medicines, confectionary, clothes and shoes, intellectual property, and electronics.

In 2005 the government strengthened control over counterfeit products by instituting proceedings against companies breaking the law of the trade brands. However further action is required if the illegal trade is to be eliminated.

Apart from state regulations 54 large consumer producers working in Russia (including British American Tobacco, Coca-Cola, HBC, Colgate-Palmolive, Danone, Kraft Foods, L'Oréal, Wimm-Bill-Dann, etc) are supporting the 'RusBrand' association, which cooperates with government bodies in order to strengthen protection of trade marks.

MAJOR RETAIL PLAYERS

Retail sales *Increasing due to consumer prosperity*

As a result of the increase in consumer income the retail market is expanding rapidly. In 2005, the retail sales growth rate in Russia was 12%.

Russia's retail market potential is estimated to be twice its current size. According to some estimates by 2010, the food market is expected to be the largest grocery market in Europe.



Russia

Retail sales growth

	2003	2004	2005
Retail sales (USD m)	147,100	193,154	245,163
Retail sales growth (% pa in RUR)	8.4	12.1	12.0
Retail sales: food (USD m)	68,047	79,846	93,843
Retail sales: non-food (USD m)	79,053	113,308	151,320

Source: EIU, July 2006

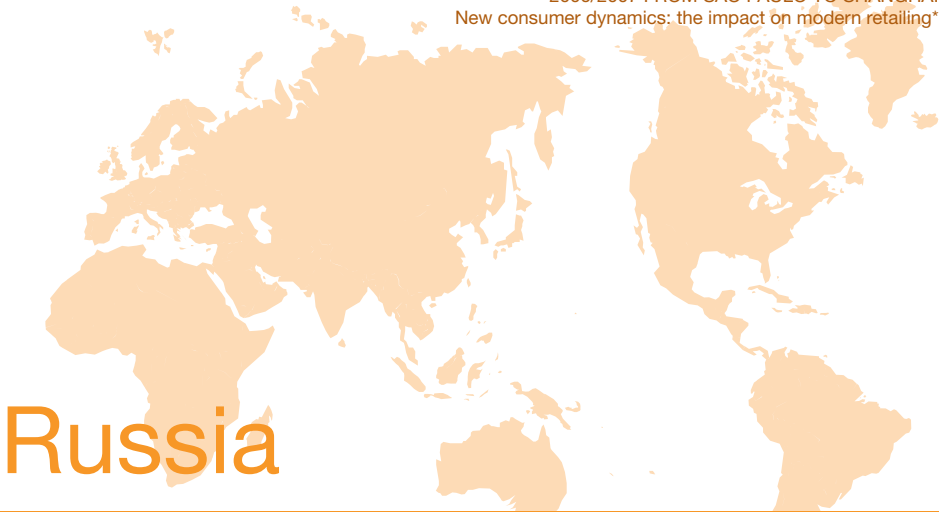
Food retail channels

*Well developed modern
retail formats*

Major food retailers by volume of sales

Ranking	Group name	Store brand	Retail formats	Number of stores 2005	2005 Gross Sales (EUR m)
1	Tander	Magnit	Convenience store	1,524	1,448.7
2	Pyaterochka Holding	Pyaterochka	Discounter	750	1,098.9
3	Perekrestok	Perekrestok	Supermarket	129	950.6
4	Dixy Retail	Dixy	Discounter	218	766.1
5	Sedmoy Continent	Sedmoy Continent	Supermarket Hypermarket Convenience Store	111	687.3
6	Auchan	Auchan	Hypermarket	7	601.6
7	Kopeyka	Kopeyka	Discounter	118	518.5
8	Viktoria Group	Viktoria, Kvartal Deshevo	Supermarket Convenience Store Discounter	134	486.9
9	Ramenka	Ramstore	Supermarket Hypermarket	49	481.3
10	MARTA Holding	Billa, Grossmart www.003.ru Colors & Beauty	Hypermarket Internet Hypermarket	80	355.1

Source: Companies' information



Russia

In 2005, self-service formats accounted for around 23-24% of the total food retail market. By 2010 their share is forecast to reach 48%.

The share of retail sales made through trade centers and self-service stores is estimated to be within the average Western European level (around 200 sq. m. per 1,000 inhabitants). Modern formats predominantly include stores selling food.

Market share by retail format (%)

	Hyper- markets	Super- markets	Discount stores	Groceries/ traditional stores	Street markets	Kiosks
2004	2	8	8	44	22	16
2005	3	10	10	41	21	15
2010 (f)	12	15	21	25	15	12

Source: Renaissance Capital estimations

Hypermarkets
A recent format which has experienced strong expansion

The hypermarkets segment has experienced rapid growth only over the past 3 years despite the fact that the first hypermarket appeared in Russia in 1997 (Ramstore chain which now operates 49 stores). According to AC Nielsen, retail audit by the end of 2005 there were 92 hypermarkets in Russia or 0.6 hypermarket per 1 million people.

At present, there are around 50 retail chains, operating in the Russian food market in hypermarket format. Auchan, which entered the market only in 2002 is now the market leader with an estimated EUR601.6 million sales in 2005. Other leading market players are Lenta, Dixy (with Megamart stores), Mosmart, Ramstore and Perekrestok.

Supermarkets
Well developed market penetration

The first supermarkets appeared in Russia at the beginning of 1990's. By the end of 2005, the total number of supermarkets in Russia was approximately 2,600 or 18 supermarkets per million people.

At present, supermarket format is losing share to discounters and convenience stores (around 40% of total sales in self-service chains in 2005 vs. 52% in 2002).

The list of leaders is dominated by Perekrestok, which had 129 shops all over the country by the end of 2005. It acceded to the 3rd place by turnover among Russian food retail chains in 2005 (EUR950.6 million). Besides this well-



Russia

Discounters/
economy-type stores
*A popular option in a price
conscious consumer base*

established player there are other important chains, such as: 7th Continent, Paterson and Billa (Rewe Group).

There are no hard discounters in the market yet and many so-called discounter chains combine the concept of supermarkets and discounters. They are often called 'economy-type' chains.

Russian consumers are still quite price-conscious, which results in the success of the 'discount/economy-type' format in the market.

There are only Russian companies operating in this market segment. The first 'discount/economy-type' store was opened in 1998 by the Kopeyka chain. By the end 2005 Kopeyka was the 2nd largest 'discount/economy type' retail chain with a turnover of EUR518.5 million in Central Russia. In 2001 Pyaterochka appeared, its turnover in 2005 amounted EUR1,098.9 million. Other significant players are Dixy (218 stores by the end of 2005) and Deshevo from the Viktoria Group (39 stores by the end of 2005).

Retail operators choose the 'discount/economy-type' format as one with the most significant prospects in 2006. The latest trends in the segment also cover development of this format in regions. It is forecasted that in the next 1-2 years this format of chains will go public.

Convenience stores
Strong growth potential

The convenience store format is expected to be the fastest growing segment until 2010. Many of the retailers working in other self-service formats are already working on or plan to develop stores in this format (e.g. Magnit, 7th Continent, Perekrestok, Auchan). Auchan added the ATAC chain (operating in this convenience store format) to its hypermarkets in 2005. They are planning to open 7 more stores by the end of 2006.

Cash and carry
*Dominated by two major
players*

There are two major players that dominate the market: METRO Cash & Carry and Lenta.

METRO Cash & Carry chain was the second largest self-service chain (after Kopeyka) in Russia in terms of growth rate in the number of stores in 2005 (growth rate was +83.3%).

The major domestic player, Lenta operates in two formats: hypermarket and cash & carry.

The Russian cash and carry stores serve both retail and wholesale clients.



Russia

Key Food retailers by format

Retail formats	Group name	Store brand	Number of stores 2005	2005 Gross Sales (EUR m)
Hypermarkets	Auchan	Auchan	7	601.6
Supermarkets	Perekrestok	Perekrestok	129	950.6
Discount stores	Pyaterochka Holding	Pyaterochka	750	1,098.9
Convenience stores	Tander	Magnit	1,524	1,448.7
Cash and carry	METRO AG	METRO Cash & Carry	22	1,453 [†]

Source: companies' information, IRG estimates

[†]METRO's annual report

Non-food retail channels

Major non-food retailers by volume of sales

Ranking	Group name	Store brand	Retail formats	Number of stores 2005	2005 Net Sales (EUR m)
1	Eldorado	Eldorado, Elektroplaza	Consumer Electronics, Mobile phones salon	772	2,410
2	Euroset	Euroset	Mobile phones	3,111	2,085.7
3	M.Video	M.Video	Consumer Electronics	58	964.2
4	Svyaznoy	Svyaznoy, Svyaznoy 3, Svyaznoy Discount	Mobile phones	894	842.3
5	SV	Technosila	Consumer Electronics	43	482.1
6	Sportmaster	Sportmaster, Sportlandia	Sporting goods	79	369 [†]



Russia

Ranking	Group name	Store brand	Retail formats	Number of stores 2005	2005 Net Sales (EUR m)
7	Alkor	L'Etoile, Sephora, O3	Cosmetics & Perfumery, Pharmacy	N/A	335.3 [†]
8	MIR	MIR	Consumer Electronics	46	312.9
9	Dixis Holding	Dixis	Mobile phones	423	307.9
10	Arbat Prestige	Arbat Prestige	Cosmetics & Perfumery	28	200.5 [†]

Source: Kommersant magazine, companies' information

[†]Estimates

Department stores
Mostly located in the richer urban pockets of Moscow and St. Petersburg

One of the segment leaders which has been present in the market since 1989 is Finland's Stockmann. In 2005, C&A and Marks & Spencer opened their stores in Moscow. In the beginning of 2006, Next and Peacocks opened stores in Saint Petersburg.

In some cases department stores occupy buildings from 10 to 50 thousand square metres but most of the Russian stores working in this format rent space in trade centres (usually up to 1.5 thousand sq. m). This can be restrictive as it does not allow chain department stores to present their full product offer (e.g. furniture, stationery, fancy goods).

Most of the modern format department stores are concentrated in Moscow and Saint Petersburg. The largest Russian traditional department stores, TSUM, GUM and Detsky Mir, are located in Moscow while Home of Leningrad trade, Large Guest Court and Passage are in Saint Petersburg. Some of these department stores have transformed their formats into a more Western-style offer. For example, since GUM was acquired by Bosco di Ciliegi, a luxury goods distributor and retailer, it has moved to a mall format. TSUM positions itself as a department store following the principles of single retail trade operators. The Detsky Mir offers a wide range of children's goods and is also developing a chain of stores in the same sector.



Russia

DIY

Positive outlook for coming years

The Russian DIY market is difficult to assess due to a high number of sales done in the open-air market. Market size estimates vary from USD6 to 10 billion in 2005. Annual market growth rate is estimated 30-40%. Increasing demand for finishing materials and an increase in new house building volumes and repair works contribute significantly to the Russian DIY sector development.

In the modern retailing sector, the chain Starik Hottabich dominates the market with around 40 stores across the country. A high market potential has also attracted attention from foreign DIY chains:

- OBI has been in Russia since 2003 (4 stores by the end of 2005)
- Leroy Merlin – since 2004 (2 stores by the end of 2005)
- Marktkauf (both food and DIY departments) – since 2003 (1 store by the end of 2005)
- Kesko – since 2005 (purchased 'Stroymaster' chain – 5 stores in St. Petersburg area)
- Castorama – since 2006 (the 1st store was opened in February 2006)

It is forecasted that by 2010 some 72 million sq. m. of new residential property will be constructed. At the same time the construction market is increasing at a lower rate than the demand for housing, which provides prospects for the DIY market.

Drugstores

A very significant segment for retail

The pharmaceutical market is estimated to be EUR7.2 billion in 2005 with 35% y-o-y growth rate. The pharmacy retail market is around 86%⁴ of the pharmaceutical market.

36.6 appeared in Russia in 1998 and is now the largest operator with 482 outlets. Rigla is the second largest drugstore chain with 360 drugstores in 2005.

Despite the fact that most of the market is still dominated by non-branded, privately-, state- or municipality-owned outlets drugstore chains developed very rapidly in 2005. Large drugstores operating in Moscow and Saint Petersburg actively expanded by acquisition of small regional pharmacy chains. In 2006 the market volume is forecast to reach EUR8 billion with 12% growth rate.



Russia

Consumer electronics
All market players are domestic companies

Market volume is estimated to be EUR12 billion in 2005. In 2005 the market leaders Eldorado and M.Video were included into the top 5 Russian retailers by turnover (around EUR2.4 billion and EUR964.2 million respectively).

In 2006, the first foreign chain announced its entry into the market (Media Markt, a part of Metro Group). The introduction of in-store consumer credits greatly contributed to the retail market development as up to 30% of sales in this sector are done with credit.

Key specialty stores

Retail formats	Group name	Store brand	Number of stores 2005	2005 Gross Sales (EUR m)
DIY	SH-Trading	Starik Hottabich	38	240
Drugstores	Drugstore net 36,6	36,6	482	200
Electronics	Eldorado	Eldorado	772 (402 franchise stores)	2,410
Apparel	Sela	Sela	532	N/A

Source: Experts estimates

E-retailing
An emerging format

Internet penetration in Russia shows a constant growth: according to the Ministry of Information Technologies and Communications the number of internet users in Russia reached 18 million in 2005. It is forecast to reach 26 million users by the end of 2006. E-retailing in Russia is constantly growing. In 2005, this market increased by around 40%.

There is no precise data on the e-retailing market volume estimates vary from EUR500 million to EUR2 billion. The turnover of the 20 largest internet shops in Russia is estimated at EUR234 million in 2005. The share of non-food sales constitutes around 90% of all internet sales.

The majority of e-shops are concentrated in Moscow which is mainly connected with low purchasing capacity of the population in regions and low internet penetration.

Electronic payments are still not developed and payment in cash to couriers and postal transfers are still dominant ways of payment in e-retailing.



Russia

Marketing

*New strategies are being
develop in response to
market concentrations*

With competition strengthening in most consumer goods and retail market segments, market players are moving from an aggressive strategy of capturing market share towards the development of marketing strategies aimed at keeping their existing market position.

The development of loyalty programs and brand management are among the most urgent marketing activities in the consumer market. Loyalty programs are being introduced in companies, but are not used efficiently; most of the programs apply discounts rather than build loyalty. Customer databases are flat and the system of information gathering is not developed.

In order to successfully compete, retailers are paying special attention to services while producers are enlarging their offer and targeting even small market segments. This diversification is resulting in large brand portfolios and consumers' confusion.

To attract more customers, FMCG companies are introducing the latest technologies in merchandising and advertising of their brands in store (e.g., LCD monitors at cash points, 'talking' POS, changing display of vertical separators, electric POS material attracting consumer's attention to the shelf, etc.).

Another trend is the development of marketing strategies for new market entrants (regional and international).

The above mentioned trends are also reflected in the growing volume of the market for advertising and marketing research services:

- The "above-the-line" market (i.e. advertising market) of around EUR3.8 billion with 28% year-on-year growth rate in 2005. The highest growth rates include internet (around 71%), television (around 37%) and outdoor (around 28%) advertising segments. Main advertisers in 2005 were: Procter & Gamble, Coca-Cola HBC, UNILEVER.
- The "below-the-line" market (i.e. promotion action & merchandising) amounted to approximately EUR1 billion in 2005, with 27% y-o-y growth rate. The highest growth rates demonstrated consumer promotion (around 31%), trade promotion (around 28%), direct marketing (around 26%) segments.

Human resources and training

*Demand for qualified
resources in retail*

The human resources market is experiencing a lack of qualified specialists in retail and consumer market segments. Project managers, sales specialists of different levels and specialists in logistics are in high demand.



Russia

In the regions the problem is particularly significant. This is mainly caused by the fact that the growth rates of the labour market growth rates do not correspond to a rapid development of retail and consumer market sectors. Experts forecast that the gap between labour demand and supply will result in even higher salary increases especially for middle level managers, financial and HR specialists.

Multinational companies are implementing their international standards of corporate culture in Russia while local companies do not have such standards and usually identify their corporate culture as 'mixed' or 'developing'.

One of the problems in the market is the poor professional education in the marketing field, which results in a lack of marketing professionals. Other skills in demand include negotiation and presentation for sales managers; delegation skills, process management, target setting and leadership skills for project managers. The regional expansion of consumer goods and retail companies also results in the problem of remote business control. Experts forecast growth in demand for 'distance management' training. Another trend is a development of interactive self-instruction education without the personal presence of a trainer.

Unlike 5 or 10 years ago when leading companies were inviting foreign specialists to hold key positions many vacancies are occupied by local specialists. Furthermore, there is a reduction in qualified personnel migration from the regions.

M&A Activity

Registered a strong increase in 2005

It is estimated that M&A activity amounted to USD59,658 million (7.8% of GDP), which is 65% more than in 2004. The total amount of deals amounted to 1,315 in 2005, the average deal constituted USD52.1 million.

In the consumer market the highest level of M&A activity took place in the brewery and retail sectors.

The latest trends in the M&A market include:

- Growing number of deals with participation of foreign investments in the consumer goods sector,
- Growing attractiveness of companies with a strong brand name (for both local and foreign investors)
- Consolidation of other segments of consumer goods market.

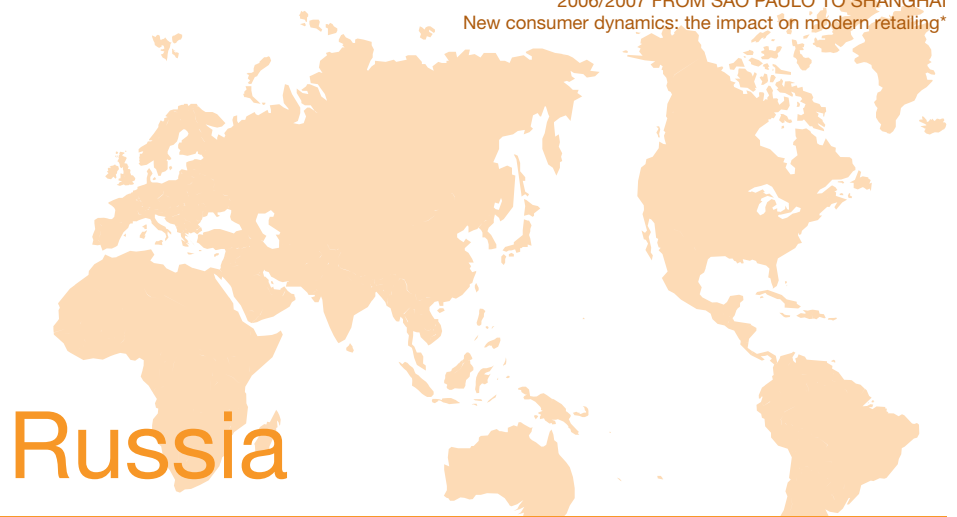
A growth of investments in the form of building new production capacities is expected in the near future.



Russia

The largest M&A deals, 2004-2006

Year	Acquiring company	Acquiree	Nature of business	Equity stake	Deal value (EUR m)
2006	Alfa-group	Pyaterochka	Retail	54%	1,178
2006	Pyaterochka	Perekrestok	Retail	100%	1,136
2006	Efes	Krasny vosto	Beverages	92.34%	360
2005	Coca-Cola HBC	Multon	Beverages	100%	583
2005	Heineken	Pivovarny Ivana Taranova (PIT)	Beverages	100%	449
2005	InBev	Tinkoff	Beverages	100%	167
2005	Heineken	Stepan Razin	Beverages	100%	100
2005	Pyaterochka	Retail chain	Retail	100%	72
2005	Kopeyka	Ekonta	Retail	100%	56
2005	Pyaterochka	Narodnaya Kopeyka	Retail	100%	49
2005	Ural-Sib	Euroset	Retail	N/A	40
2005	Sedmoy Continent	Altin chain	Retail	N/A	29
2005	Billa (Rewe Group and Marta holding)	Prodmak	Retail	100%	28
2005	Kopeyka	Samara-Product	Retail	100%	28
2005	Heineken	Severniye Vetry	Beverages	100%	N/A
2005	Heineken	Baikalskaya beer company	Beverages	100%	N/A
2005	BBH	Yarpivo	Beverages	25.9%	N/A
2005	Inditex	Stockmann – Krasnoselskaya (Zara chain)	Retail	100%	40
2004	Bosco Di Ciliegi	GUM	Retail	50.25%	79
2004	Troika Dialogue	Arbat Prestige	Retail	40%	40-125
2004	Heineken	Sobol Beer	Beverages	100%	55
2004	Alfa Group	Sun Interbrew	Beverages	10.4%	49
2004	Sedmoy Continent	BIN ('Petrovskiy' chain)	Retail	100%	40-55
2004	Unnamed US Venture Fund	Rusagrocapital	Agribusiness	Blocking stake	47
2004	ENR Russia Invest SA/ Eastern Property Holdings	Mosmart	Retail	N/A	39
2004	Kalina	Dr Scheller (Germany)	Cosmetics	30%	16



CHALLENGES

Struggle for retail space

RETAIL AND CONSUMER CHALLENGES, OPPORTUNITIES AND EMERGING TRENDS

The struggle for space is one of the challenges for both established chains and newcomers. This issue is even more serious in Moscow where the availability of large trade space in a good location such as the city centre or along busy highways within the city boundaries is diminishing. Due to the lack of space, retailers are having to place their stores on the outskirts of the city or in the suburbs.

It is a common practice that retailers develop new formats based on the specifics of offers from property developers rather than their own predetermined format. An offer from a property developer may be proposed in a package that includes several areas of different formats which cannot be purchased separately.

Logistics and supply chains

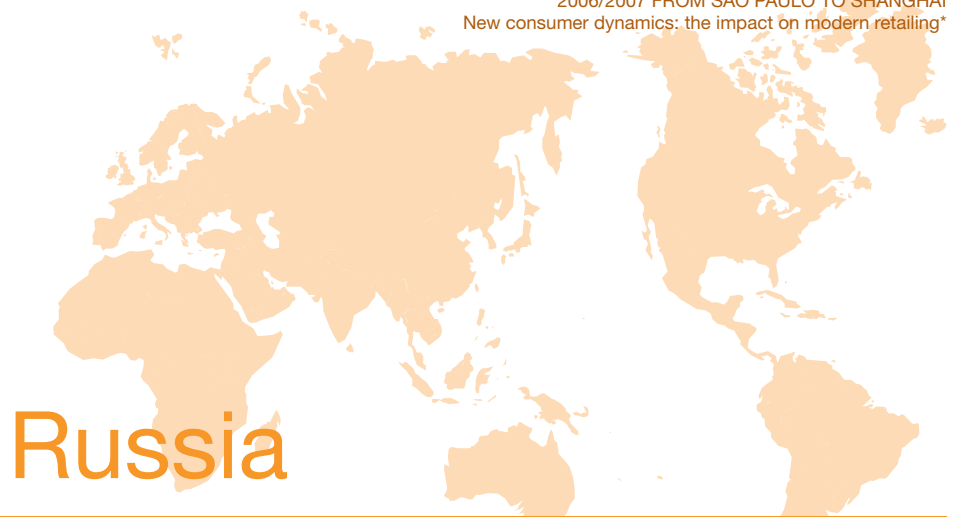
Due to the size of Russia (11 time zones) and the geographical position of cities with populations over 1 million, logistics remains a significant problem. Retailers experience difficulties on the regional level where territorial remoteness has a large impact. To deliver a load from one part of the country to another by railway takes about 6 to 7 days.

Cross-docking facilities are not available in Russia. Logistic service providers are only starting to develop it. Generally they are former transport, warehousing and distribution operators. Late delivery is one of the main challenges for retailers resulting from imperfections in the logistics system.

Significant changes in the relationships with the suppliers are gradually taking place. Several years ago, retailers were in a rather dependent position towards suppliers. However, retailers have now become strong enough to demand from the suppliers stiff delivery schedules, lower prices, long-term credits, required packaging and marking.

Trade credits from suppliers (up to 1-2 months) are usual practice in food retailing. Such supply conditions often put FMCG producers into difficult financial situations.

A number of procurement unions expect to gain more bargaining power and the optimisation of logistics expenses is predicted within the next 2 to 3 years.



Potential WTO accession

Russia has been attempting to enter the WTO since 1994. According to the latest negotiations Russia could join WTO at the beginning of 2008.

In Russia besides providing equal competition conditions for the trade of goods and services, WTO accession will imply substantial liberalisation of the service and production sectors for foreign direct investment. One of the expected results is lower customs duty which may result in an increase in the share of imported goods and provoke tougher competition for the domestic producers. This is especially important in the food, pharmaceutical, chemical, electronics industries and the retail trade.

OPPORTUNITIES

Sustained economic growth

Since the 1998 crisis, the country has enjoyed solid economic growth compared to the low levels in Western countries.

Russia GDP is on an upward trend with forecast annual growth of 4-5% in the coming 2-3 years. In 2005, GDP per capita was EUR3.9 K (vs. EUR 3.5 K in 2004).

Modernisation of Russian retail sector and change in shopping habits

Russian consumers' behaviour has become closer to European standards. Shopping in trade centres and stores of self-service formats is gaining popularity among inhabitants of big cities. Due to the growth in consumers' incomes, the volume of consumption has increased.

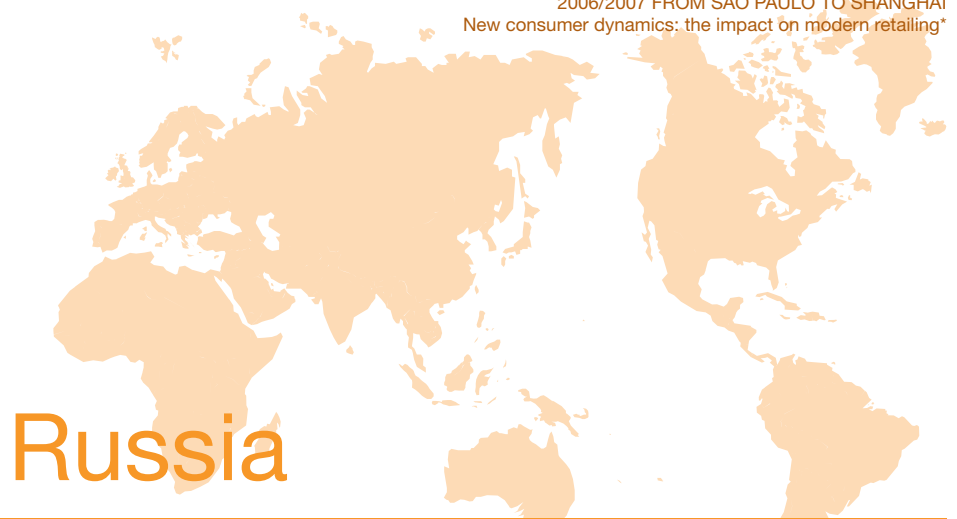
Consumers are starting to pay more attention to healthy products. Also an increase in premium-class brands has been observed. Consumers are ready to pay extra money to get a higher level of comfort.

Development of consumer credit

The introduction in 2000 and the development of credit sales made a great impact on the development of such sectors as consumer electronics, mobile phones, fur/leather coats, furnishing and cars. It is estimated that retail sales made in credit amounted to 14% of all retail sales in 2005 or to EUR31 billion⁵. The share of sales made in store credit (except credit cards) varies for different sectors from 1 to 35%.

Major Russian and international banks are actively developing their retail business by offering new products and services, extending retail networks and opening point of sales in shopping malls.

5 Source: Central Bank of Russian Federation, Ministry of Economic Development and Trade, Retail Banker International



EMERGING TRENDS

Regional and outward
expansion

New comers open new
stores in regions

Development of private labels

However Russia is still in the early stages of consumer finance market development compared to other Western and Eastern European countries. Cash loans still dominate (around 60% of total consumer finance market).

Experts forecast that along with further development of credit cards and mortgage loans, the volume of retail purchases made with credit will reach EUR63 billion by 2008 and include almost 20% of all retail purchases in the country.

Big cities are close to saturation and there is a need for regional expansion if a company wants to maintain its growth rate at a certain level.

In 2005, cities with a population of 500,000 and less were targeted by local and foreign chains. However Moscow still accounts for roughly 1/4 of all retail sales in Russia, remaining the most prosperous city in Russia and thus the most attractive location for both foreign and domestic investors.

Some of local retailers are developing regional chains by extending franchising projects, for example, Eldorado consumer electronics chain.

Another widespread phenomenon is the acquisition of smaller chains by leading retailers. This trend is expected to intensify in the short term.

Moscow is traditionally an entry point of retail trade in Russia. Most of the largest retail operators starting their business in the country first opened new stores in Moscow. However, recently there were a number of entrants which opened new stores or announced their plans to open new stores in regional cities (e.g. Castorama opened its first store at the beginning of 2006 in Samara, Media Marketing belonging to METRO Group is planning to open its new store in Saint Petersburg in 2006-2007).

This trend is connected with growing incomes of population in regions, growing competition in Moscow and lack of proper retail space in the capital city.

Private labels in Russia appeared in 2001 (in Ramstore and Perekrestok). At present all major food retail chains are developing private labels. They can either be branded as a chain (e.g. Perekrestok, Ramstore, Paterson) or in a different way (e.g. 'Romashkino' by Kopeyka, 'Aro' by Metro CC.).



Russia

Multi-purpose shopping centres

The share and role of foreign companies in the Russian consumer market is increasing

The leaders by the number of products under private label in their offer are the supermarket chains – Perekrestok (around 600), and Sedmoy Continent (around 250 in 2005; it plans to have 1,000 by the end of 2006). The share of private labels in total chain sales is growing. Overall their share does not exceed 1-2%. However in some discounter chains (like Pyaterochka or Kopeyka) it can reach 15%. Most of the chains that already have private label products have announced their plans to increase their number (Perekrestok, Sedmoy Continent, Ramstore, Magnit (Tander).

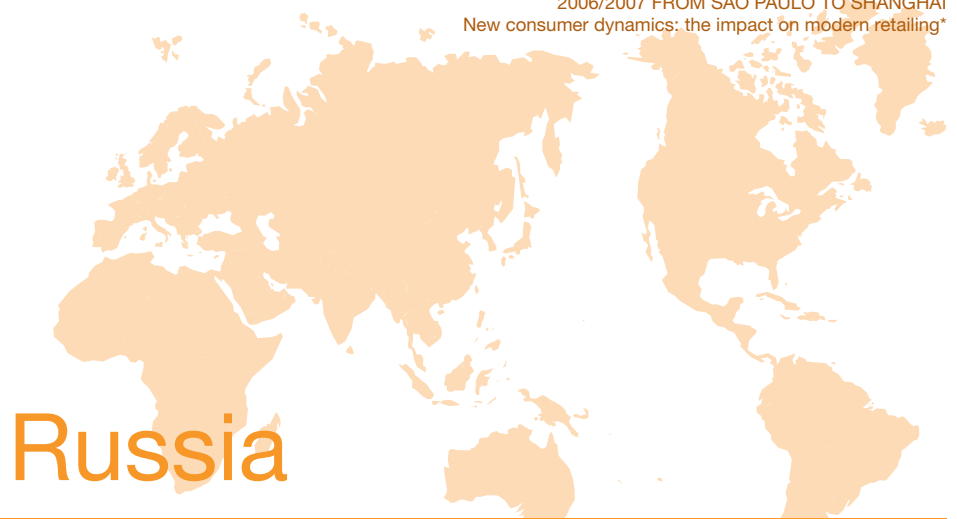
Leading manufactures (such as WBD, Lebedyansky) produce private label products for retailers, which helps them get better conditions of work (marketing budgets, selling space, entrance fee, etc).

The most popular private label categories are milk, canned food, juice, water, wine, bread, frozen vegetables, cereals, eggs and sauces.

There are some examples where private label products copy the appearance of existing brands in order to win customers who do not see the difference. This is not a common practice but we expect it to be more widespread in the next 1-2 years.

Large-scale shopping malls combining under their roof retailers selling different kinds of goods (fashion, electronics, furniture, food, etc), food courts and entertainment facilities are developing rapidly. While 1-2 years ago the largest number of shopping centres was concentrated in Moscow, at present they are actively operating in all cities with a population of over 1 million people.

The IMS Group estimates, multinational corporations are expected to grow organically, at 15-20% on average in the next 3 years and via acquisitions/ partnerships with successful local companies and new product launches. In the next 3-5 years, foreign companies will be one of the drivers of economic growth in Russia, contributing not just to the total output and total investments but also to the improvement of productivity and corporate standards in the internal market.



Finance rising through Initial Public Offering (IPO)

In the past 3 to 4 years many Russian retailers have announced their plans to finance their activity through IPO in the near future. Among 2005 IPOs are 7th Continent, Pyaterochka, Kalina, Magnit.

IPOs are becoming a serious test of the competitive ability of Russian retailers. In opposition to European market stagnation, Russian economic growth strengthening foreign investors' interest towards Russian businesses. The positive dynamics of retail chains is stimulating demand of financial investors for Russian companies stocks. The main purposes of IPO entrance for Russian retailers are: to get additional financing for realisation of impetuous growth strategy, to enlarge the number of investors and get access to inexpensive western resources, to sell business to strategic investors as expensively as possible and to get a guaranteed stable income. But from the experts' point of view these goals may be achieved only by 3 to 5 national market players.

Second tier companies may want to complete an IPO but they are often not ready to meet the requirements of a public company (for example, transparency reporting frameworks, regulatory requirements, governance and information system needs).



Case Study I

Inbound multinational company – Investment: strategic acquisition of a Russian retail operation

KEY DRIVERS

The Russian market is developing a higher profile for major international investors year after year. Consumers' soaring disposable income and the country's unsaturated consumer market provide a huge potential for retail operations growth. The sector presents plenty of scope for new retail formats, such as supermarkets and hypermarkets; Russia is lagging behind its Eastern European neighbours in these segments.

Foreign companies coming to Russia face a dilemma as to whether they start from scratch or buy a Russian retail chain and re-brand its outlets to new standards. In this case study an international company went for the latter option of acquiring a Russian retailer. What steps did it need to take?

Selecting an acquisition target

While the challenges of making an acquisition are similar in all environments, the specificities of the Russian market needed to be taken into account in the process of selecting a target for acquisition.

For example, shortage of retail floor space is among the principal drivers behind Russian acquisition deals where the target has suitable sales premises. Under the circumstances, importance was placed on the number and format of the outlets as well as the penetration of the target's operations. The branches had to generate profit and their size had to match the potential of the region where they are located.

Similarly, intellectual property rights are not well established in Russia. There have been cases where a target was acquired only to find that title to its intellectual property could be challenged. The company recognised that the acquisition of a Russian retail chain carried risks from the transfer of intellectual property rights held by the acquisition target, such as branding, managerial know-how, personnel training methodologies, etc and clarified such issues by carrying out due diligence and business risk analysis.

The main acquisition criteria considered by the company included:

1. Strategy: e.g. clear development vision, price position, target audience, brand, development of privately labelled products, market share, brand recognition, etc.
2. Organisation: e.g. corporate governance maturity, transparency, investment policy, group structure, etc.

3. Operations: e.g. formats; geographic presence; location of outlets; supply chain organisation; personnel management; systems in place for planning, budgeting, accounting, reporting, controlling and managing risks; profitability of operations; skilled personnel on staff, etc.

In establishing acquisition related costs, the company needed to realise that Russian companies seeking to sell their business have clear expectations of its value. Russian corporate retailers have historically been in a relatively strong negotiating position and, more often than not, have high expectations for pricing. These expectations may not be supported by its history and, therefore, the company ran the risk of paying more for the business than it was worth.

Closing the deal

Two important areas had to be addressed while closing the deal. First, the legal format of the deal needed to match the actual substance of the business. Second, the assets' safety had to be assured for the transition period.

Post-deal integration

As is usual upon deal closure, it was necessary to bring the operations of the acquired company into compliance with the acquirer's standards.

Joint operations had to be planned to achieve synergy. This was largely accomplished via economies of scale, accessing new markets, geographic advantage of the location, optimising the supply chain, new opportunities for personnel training, etc.

More specifically, the target company had geographically dispersed operations and its own supply chain logistics. After the deal was completed, the buyer could either preserve the status quo or transform the supply chain in accordance with the acquirer's requirements. The buyer decided to transform the supply chain but recognised that this would take time to do properly.

The company also had to plan for managing the new client base acquired through the acquisition. It was important to understand how to manage stakeholders' expectations and how they could benefit from the new corporate combination.

As the company was new to Russia they questions regarding the reporting procedures of the Russian company they bought. After the acquisition, the company adjusted the reporting system to its requirements and international standards.

Overall the company learned a lot about the risks of doing business in Russia. The acquisition was successful but the company experienced the greatest challenges with the post acquisition integration.

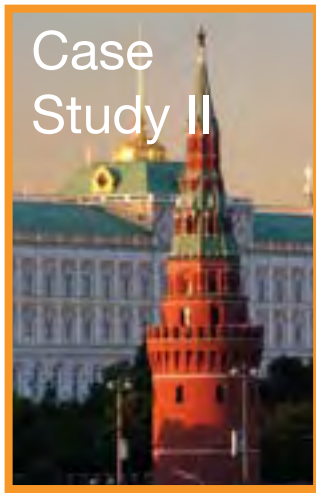
PRICEWATERHOUSECOOPERS ASSISTED IN THIS CASE STUDY BY PROVIDING THE FOLLOWING SERVICES:

Prior to acquisition:

- Analyse the market and identify the potential acquisition targets
- Evaluate the target's corporate governance system
- Perform due diligence of the target
- Perform valuation of the target's business (before an IPO)
- Perform tax and legal due diligence on the target

After the acquisition:

- Assess the new company's compliance with the Russian tax legislation
- Perform restructuring of the unified company
- Develop an investment strategy of the unified company
- Post-merger integration
- Develop key performance indicators for the unified company



Case Study II

Inbound multinational company – Starting from scratch

KEY DRIVERS

Due to the difficulty of identifying an appropriate acquisition target and the high costs of acquisition and subsequent integration, the client had made the decision to develop its business in Russia “from scratch”. What were the successive steps the company took for this first-time development?

Determining the strategy for entering the Russian market

Firstly, the company established the strategy’s main features and identified key success factors. This included answering a number of questions specific to the Russian environment, such as:

- How would the company adjust its business model for working in Russia?
- What would be the format of the company stores in Russia?
- What would be the company’s franchising policy?
- In which cities would the company open its stores?
- What were the company’s competitive advantages in the Russian market?

The next steps analysed the implications of an entry in the Russian market.

One of the issues faced by the company was the lack of skilled personnel, especially for technical and support functions. Although the Russian workforce is generally held to be well educated and skilled, population decline and job competition have left some functions with a shortage of skilled staff.

The company was new to the Russian market and was very motivated to capture a fair market share. They had difficulty in finding sites within city limits due to the shortage of trading space, and their locations were not the most favourable. Therefore, they had to find other ways for attracting customers in addition to a convenient location. Lower prices and wider product ranges than their competitors were two significant factors in developing customer loyalty.

To succeed in the Russian market, the company needed to adjust its product ranges to the tastes and preferences of the Russian customers. In Russia, the company could use its well-established skills in customer relations and develop new approaches to attracting and retaining

customers. However, the company also had to understand its local target audience (the average income, gender, social status, place of residence, etc.). This was important both in Moscow and in the regions where the level of income remains noticeably lower.

Although the Russian hinterland is very attractive from the business development point of view, it does not have the required logistic infrastructure. The latter had to be created from scratch. Entry into the Russian regions entailed significant investments in supply chain development, including the organisation of the distribution centres, construction of warehousing facilities and acquisition of transportation companies.

Successful development of the company’s business in Russia depended, to a large extent, upon the exact wording used in the statutory documents and the tax structure. Therefore, those issues were considered well in advance to reduce the chances of last minute problems.

The normal group policies and controls had to be tailored for Russia. Security of assets and operations in Russia was a concern. Special attention was paid to corporate security systems, ERP systems and accurate financial reporting.

Strategy implementation

After the company considered all the advantages and disadvantages associated with a Russian market entry, it prepared a detailed business plan for the company’s future development. In the course of its operations in Russia, the company also faced the following needs:

- Supply chain management
- Financial statements audit
- Internal audit
- Improving stores’ operating efficiency
- Overall cost control
- IT Management solutions

PRICEWATERHOUSECOOPERS ASSISTED IN THIS CASE STUDY BY PROVIDING THE FOLLOWING SERVICES:

By arranging strategic sessions to plan for a number of issues:

Strategy

- Strategic plan assessment
- Market analysis (review of the key issues)
- Facilitation of the strategic session
- Assistance in the course of the marketing strategy development
- Financial planning

HR

- Compensation system development
- Organisational structure development

Business processes improvement

- Cost reduction
- Store management
- Business processes design and improvement
- Business portfolio analysis and main competitive advantages assessment

Financial Statements

- Management informational system controls
- Accounting and reporting
- Executive accounting

Controls

- Developing an internal control system for financial indicators
- Key operating controls



Russia

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Renaissance Capital
Retail Banker International
Rosstat



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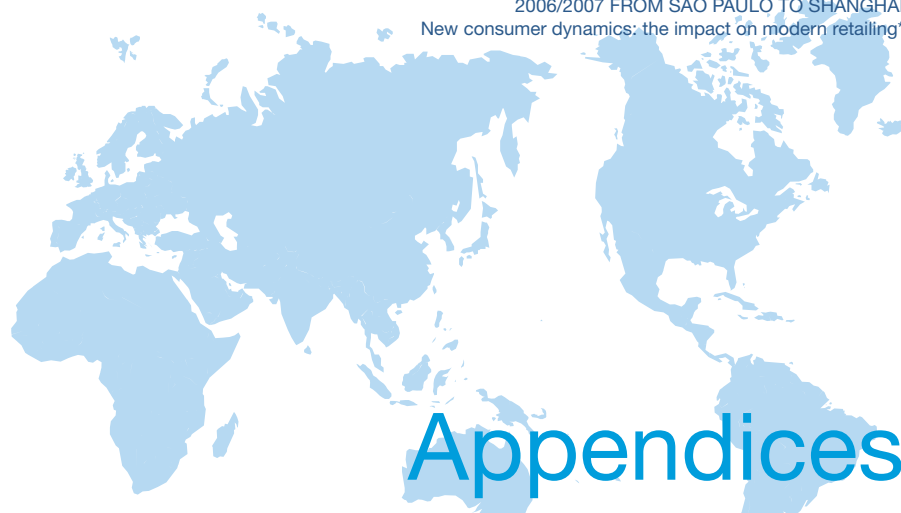
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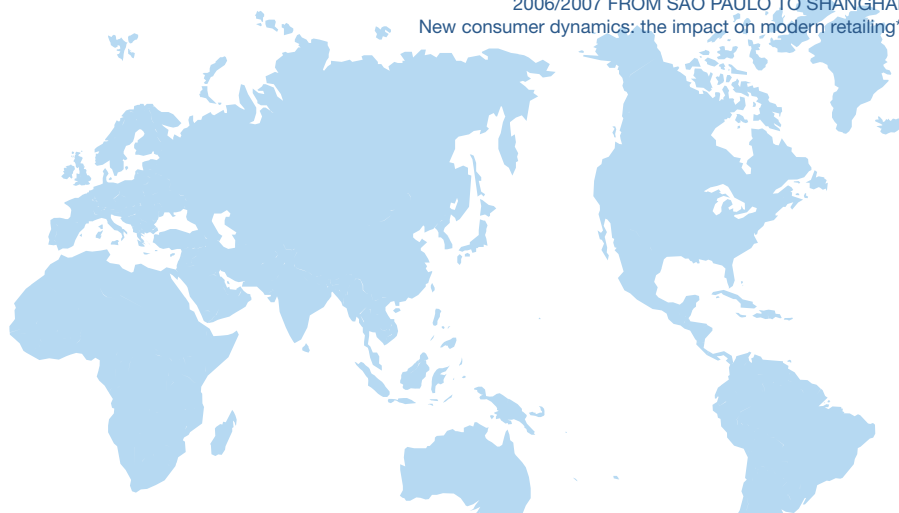
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Appendices

ABBREVIATIONS/ACRONYMS

ASEAN	Association of Southeast Asian Nations	IMF	International Monetary Fund
bn	billion (in the tables)	IPO	Initial Public Offering
BPO	Business Process Outsourcing	IPR	Intellectual Property Rights
Cagr	Compounded annual growth rate	IT	Information Technology
CEPA	Closer Economic Partnership Arrangement	JV	Joint Venture
CPG	Consumer Packaged Goods	K for k	Thousand(s)
CPI	Consumer Price Index	MERCOSUR	Mercado Comun Del Sur
CRM	Customer Relationship Management	MOFCOM	Ministry Of Commerce (in China)
CSR	Corporate Social Responsibility	M&A	Mergers & Acquisition
DIY	Do It Yourself	m or mn	million (in the tables)
(e)	estimate	N/A	Data not available
EC	European Commission	OBP	Outline Building Permit
EIU	The Economist Intelligence Unit	POS	Point of Sale
EMU	European Monetary Union (EU 25)	PRC	People's Republic of China
ETDZ	Economic and Technological Zone	PC	Personal Computer
EU	European Union	PPP	Purchasing Power Parity
EUR	Euro	Q1	Quarter 1 (Jan, Feb, Mar)
(f)	forecast	R&D	Research and Development
F&B	Food and Beverage	RFID	Radio Frequency Identification
FDI	Foreign Direct Investment	SCM	Supply Chain Management
FICE	Foreign Invested Commercial Enterprise	SPE	Special Economic Zones
FIE	Foreign Invested Enterprise	TV	Television
FMCG	Fast Moving Consumer Goods	USD	US Dollar
FY	Fiscal Year	VAT	Value Added Tax
GDP	Gross Domestic Product	WTO	World Trade Organization
HHT	Handheld Terminal	WFOE	Wholly foreign owned enterprises
HR	Human Resources	y/y	year to year
ICT	Information and Communication Technology	YoY or y-o-y	year on year

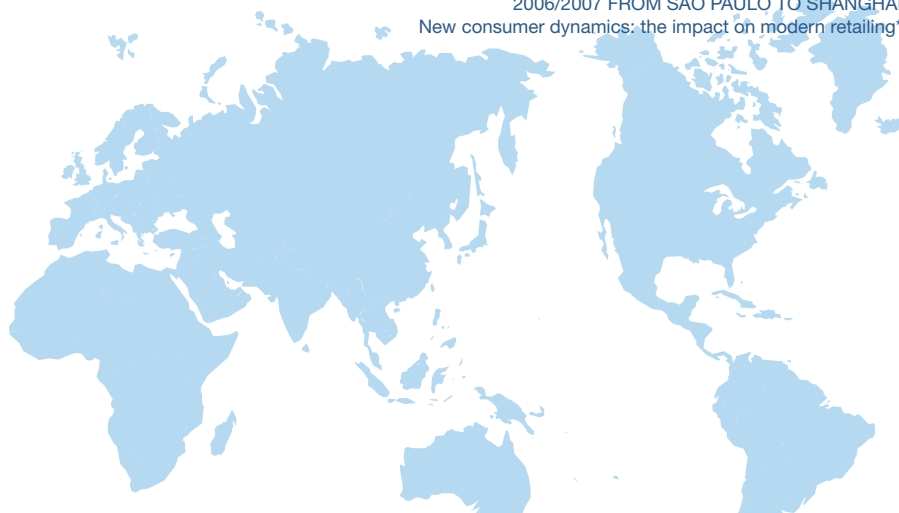


CURRENCIES VS. US DOLLAR

Within the country reports, in some cases, key figures and sales turnover have been provided in local currencies. The table below provides the average conversion rate in USD for the year 2005 for the six countries in the scope:

Country	Currencies	1 USD
Argentina	Argentine Peso (ARS)	2.9
Brazil	Brazilian Real (BRL)	2.4
China	Chinese Yuan Renminbi (RMB)	8.2
India	Indian Rupee (INR)	44.1
Poland	Polish Zloty (PLN)	3.2
Russia	Russian Rouble (RUR)	28.3

Source: EIU, July 2006



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PricewaterhouseCoopers local offices provide their sources of information in each of the six countries in the scope. Complementary research was made using international financial or economic institutions (World Bank, OECD, IMF), national statistical offices as well as economic and industry intelligence services. Macro-economic data and charts have been sourced from the Economist Intelligence Unit. Companies' annual reports have been used in many cases to complete the retail and consumer goods players' tables. An exhaustive list of the all sources used is available below:

[Executive Summary and all PricewaterhouseCoopers' country reports from Argentina, Brazil, China, India, Poland and Russia](#)

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Acknowledgements

I would like to thank the local PricewaterhouseCoopers offices in each of the six countries covered by this study and the PricewaterhouseCoopers Global Retail & Consumer team, very warmly indeed for their enormous involvement and support during the past six months in gathering and reviewing the information and insights that were necessary for the country reports. In particular, I would like to thank our local team based in:

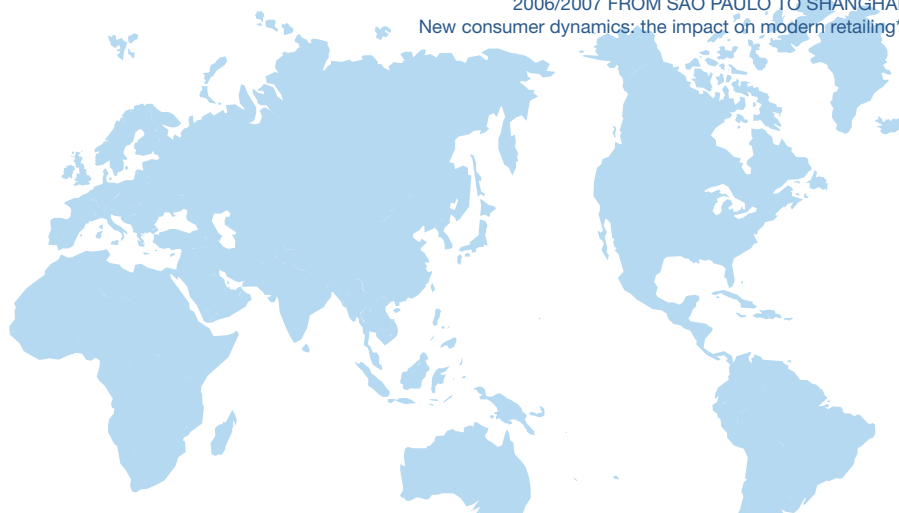
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Brazil	Márcio Vieira, Alexandre Pierantoni, Luis Reis, Mauricio Girardello, José Onto, Rodolpho Valadão, Gilberto Vianna
China & Hong Kong	Sonny Doo, Betty Ko, Graham Matthews, Anthea Wong, Andrew Yuen, Tiffany Wong, Jenny Ng, and special external assistance from Regina Yu
India	N.V. Sivakumar, Vivek Mehra, Asitava Sen, Lalitha Banerjee, Roshini Murjani, Aprajita Khokha
Poland	Katarzyna Witaszewska-Król, Agnieszka Ostaszewska, Jakub Lech, Łukasz Feliks, Aleksandra Tarasiewicz, Izabela Chojnowska, Daniel Flis, Aleksandra Grabu
Russia	Chris Skirrow, Irina Martakova, Jane Harrison, Polina Nemirovchenko

I would also like to thank the following Retail & Consumer industry regional partners of PricewaterhouseCoopers for reviewing the study with a critical and constructive eye: Henrique Luz, PricewaterhouseCoopers Retail & Consumer South America Leader, and George Johnstone, PricewaterhouseCoopers Retail & Consumer Central and Eastern Europe Leader.

Moreover, special thanks to our friends and external consultants, Denise Larking-Coste (Business Communication) and Patrick de Saint Martin (Observatoire Vigie) for their advice and input.

Last but not least, I would like to address warm thanks to the Global Retail & Consumer Marketing team, Anne-Sophie Lacarelle-Gasse, Florence Tang, Nitya Gupta and Charlotte Dewast from the PricewaterhouseCoopers Paris office, as well as Anna Lai, Jennifer Yep and Zona Chu from the PricewaterhouseCoopers Hong Kong office.

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