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Knight Frank

Better late than never! With a logjam on major policy issues and inclination for introducing disastrous rules like General Anti-Avoidance Rule (GAAR) amidst high inflation and faltering economic growth, the sentiment of doing business in India took a severe beating. However, although the weakness in the economy, as reflected in the macro economic data, still prevails, the sentiment has certainly changed in the last few weeks. This sea change in the business sentiment has not come easy. It took the Indian government great amount of soul searching and tough measures on the policy front to boost the business sentiment in the country. The measures like cutting back on fuel subsidy and liberalization of Foreign Direct Investment (FDI) policy in sectors like single-brand and multi-brand retail, aviation, broadcasting and power exchange within a very short span has come as a positive surprise.

The measures have a bearing on the real estate industry in the sense that demand for property is a derived demand. In the short term it is driven by the sentiment in the economy and in the long term it is the economic fundamentals that drive this industry. While the sentiment boost by the recent measures will impact overall real estate sector, the relaxation in FDI limits in the retail sector would have direct impact on the commercial real estate market. The entry of foreign retailers would not just address the high vacancy in retail real estate but also help in the growth of such developments in future.

WHILE THE SENTIMENT BOOST BY THE RECENT MEASURES WILL IMPACT OVERALL REAL ESTATE SECTOR, THE RELAXATION IN FDI LIMITS IN THE RETAIL SECTOR WOULD HAVE DIRECT IMPACT ON THE COMMERCIAL REAL ESTATE MARKET

In India, for the purpose of foreign investment norms, retail industry is classified in to three categories viz, cash & carry wholesale trading, singe brand retail and multi brand retail. FDI in wholesale trade was opened up for more than a decade and gradually over this period the investment limit has been increased to 100%. As per the FDI norms for this category sale to retailers, industrial, commercial, institutional or other professional business users shall be allowed. Restriction on sale to consumers makes it a Business to Business (B2B) model. Large multinationals like Metro and Walmart are already present in the country through their cash and carry stores.

The front end sales i.e. sale to consumers is classified under single brand retail and multi brand retail wherein both of these have a different set of regulations with respect to foreign investments. Single brand retail was opened to foreign investment in 2006 with a cap of 51%. This cap constrained foreign retailers desirous of entering India albeit with a full control. The limit, subject to fulfilment of certain conditions, was hiked to 100% in January this year. Notwithstanding the 100% FDI permission in January 2012, the FDI inflow in the single brand retail category has not picked up.The primary reason that put down the interest of foreign players was conditions on sourcing from small scale industry. Another reason that remained a concern was

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ownership of such entity. The following are the major observations for FDI in single brand retail:

- Products to be sold in the venture should be of a single brand only.
- The Product under consideration should be sold under the same brand internationally.
- The permission would cover only products which are branded during manufacturing.
- As per the earlier rule, Foreign investor should be the owner of the brand. However, this condition was a hurdle and hence is waived now in Press note 4 of 2012 released on 20th Sep 2012. As per this revision,only one foreign entity, whether owner of the brand or otherwise, shall be permitted to undertake retail trading in the country, for the specific brand. Hence, a major issue has been addressed.
- As per the earlier rule, in case of proposals involving FDI more than 51% mandatory sourcing of minimum of 30% of value of products sold had to be done from Indian small industries. This condition was a hurdle and hence is waived now. According to the Press note 4 of 2012 released on 20th Sep 2012, sourcing of minimum of 30% of value of

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Table 1: Major conditions for a foreign retailer to be compliant with the revised FDI norms in India

Particulars	Cash & carry wholesale trading	Single Brand	Multi Brand
FDI limit	100%	100%	51%
Entry route	Automatic approval	Government approval	Government approval
FDI investment size	Not applicable	Not applicable	Minimum USD 100 mn.
Investment in back end infrastructure (excluding land cost)	Not applicable	Not applicable	Minimum 50% of the total FDI
Condition of sourcing 30% of purchase from small scale industry	Not applicable	Preferable (Not a mandatory condition)	Mandatory
Sales model permitted	B2B	B2B, B2C	B2B, B2C
E-commerce	Allowed for B2B sales	Not Allowed	Not Allowed

Source: DIPP, Knight Frank Research

goods purchased would have to be done from India, preferably from small industries. This procurement requirement would have to be met, in the first instance, as an average of five years' total value of the goods purchased, beginning 1st April of the year during which the first tranche of FDI is received. Thereafter, it would have to be met on an annual basis. While the amendment has relaxed the basis of calculation of sourced item from sale value of the retailer to the purchase value of the input items and also provides an elongated timeline for such compliance, the biggest takeaway is that the revision essentially removes the condition of sourcing from small industries. While the sourcing still has to be done from India, the retailer would be free to choose the vendor for such sourcing.

• E-commerce is now categorically disallowed in single brand retail. This norm is in line with the spirit of the FDI norms which essentially is devised to enhance competitiveness of Indian retail industry by attracting investment in production and marketing.

• The permission is not under automatic mode and government approval is required to confirm the eligibility of the products proposed to be sold under single brand retail. Any addition to the product/ product category even within the same brand name requires fresh approval.

Notwithstanding the increase of FDI limit in single brand retail from 51% to 100% in January 2012, investments failed to pick up in the subsequent six months (Jan 2012-June 2012). This happened even as the country witnessed an overall FDI inflow of USD 16.74 bn. during these six months. As a result, the share of FDI in single brand retail fell from 0.03% in December 2011 to 0.02% in June 2012. The biggest contention was the condition on ownership and sourcing. With these being eased now we expect the improvement in FDI inflows will be visible in the FDI inflow over the next 6 -12 months.

NOTWITHSTANDING THE INCREASE OF FDI LIMIT IN SINGLE BRAND RETAIL FROM 51% TO 100% IN JANUARY 2012, INVESTMENTS FAILED TO PICK UP IN THE SUBSEQUENT SIX MONTHS

The third category of retail industry from the FDI norms perspective is the multi brand retail. The issue of foreign investment in multi brand retail has remained the biggest policy contention in the last few years and created a lot of political upheaval in the country. Lot of concern has been raised by stakeholders with respect to its impact on the local industry. Amidst this concern and political upheaval, the government allowed FDI in the category by issuing Press note 5 of 2012 on 20th September 2012. The following observations on multi brand capture the essence of the new norms:

Table 2: FDI inflow between Apr 2000 - June 2012

Particulars	FDI (USD Mn.)	Share in total FDI in the country
Total FDI inflow in the country	174,714	100%
Construction development (Housing and allied activities)	21,088	12%
Cash & carry wholesale trading	3,445	1.97%
Single Brand retail	42.70	0.02%

Source: DIPP, Knight Frank Research

• Minimum FDI investment of USD 100 million for a multi brand retail venture is required

• Minimum 50% of FDI should be in capital expenditure on backend infrastructure within 3 years of the first tranche of FDI. Back end infra will include all the following activities except expenditure on land cost and rentals

- Processing
- Manufacturing
- Distribution
- Design improvement
- Quality control
- Packaging
- Logistics
- Warehouse
- Agriculture market produce infrastructure

• At least 30% of the value of procurement of manufactured/processed products purchased shall be sourced from Indian small industries. This procurement requirement would have to be met, in the first instance, as an average of five years' total value of the manufactured/ processed products purchased, beginning 1st April of the year during which the first tranche of FDI is received. Thereafter, it would have to be met on an annual basis. Although this condition on sourcing prevails for multi

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brand retail, the elongated timeline for such compliance would be a relief for a retailer.

• There are conditions for setting up retail outlets. In states/union territories it has to be in cities with more than 1 mn. population or 10 km. around such city limits. In states/union territories not having cities with a population of more than 1 million it can be set up in any city, preferably the largest city or 10 km. around such city limits.

• E-commerce is categorically disallowed in multi brand retail in line with norms in single brand retail where it is not allowed.

But the biggest point is that the policy on multi brand retail is only an enabling policy and the State Governments/Union Territories would be free to take their own decisions in regard to implementation of the policy. This choice in the hands of state would restrict the benefits from foreign investment from percolating to the desired level. With the government allowing foreign direct investment in multi-brand retail stores, it is imperative to examine how the local retail companies have been faring. Hence, we studied the financial indicators of the top-six most referred retail companies of India. This set of six companies has been used as a representative of the Indian retailing industry.

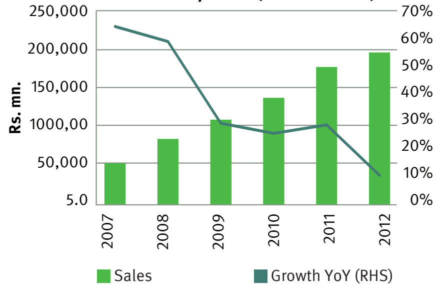
Increase in middle-class population and high disposable income led to heightened demand for the branded products in India. Taking cognizance of this, retailers expanded their business across the length and breadth of the country. This expansion fuelled the revenue growth of the retail companies, which witnessed an annual growth of 30% during 2007-12. Among these companies, Pantaloons, Shoppers Stop and Trent emerged as the largest retailers registering a five-year average annual growth rate of 30%, 27% and 26% respectively. However, the revenue growth momentum decelerated mainly due to financial crisis of 2008-09 which led retailers to slow down their expansion plan. Operating profits i.e. Profit before Depreciation, Interest and Tax (PBDIT) grew at an annual rate of 34% during 2007-12 while operating profit margin increased from 7.9% in 2007 to 9.3% in 2012 indicating healthy business operations. However, the profitability as measured by the Profit after tax (PAT) has taken a severe beating during this period mainly on account of high interest

Table 3: Market capitalisation of select retail companies in India as on 25-Sep-12.

Companies	Rs.mn.
Pantaloon Retail	44,420
Shoppers Stop	32,120
Trent	25,866
Brandhouse Retail	643
Provogue	832
Cantabil Retail	274

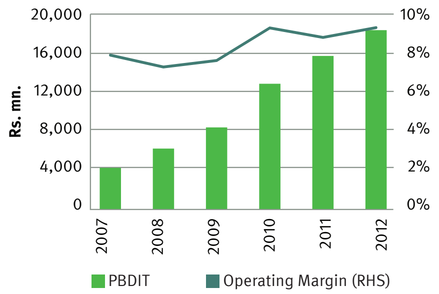
Source: Capitaline

Chart 1: Revenue trend of select retail companies (FY 2007-2012)



Source: Capitaline

Chart 2: Operating Profitability trend of select retail companies (FY 2007-2012)



Source: Capitaline

and real estate cost.

As per the FDI policy "It is the intent and objective of the Government of India to attract and promote foreign direct investment in order to supplement domestic capital, technology and skills, for accelerated economic growth." The analysis indicates that the retail industry has tremendous potential for growth and its operations remain healthy even during this slump. However, profitability has severely crippled on account of incidental costs. Participation of foreign players can address this lacuna not just by bringing in investments, but also expertise and scale of operations that equip them to contain several cost components including real estate. Fresh investment in the sector would ease the capital constraints faced by most of the domestic players and

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there is a possibility of reduction in overall cost of capital.

Farm realization would increase on account of direct sale to the organized retailers. The prevailing distortions in the present supply chain system, particularly in food articles, would likely be addressed. While the growth of industry will lead to further employment generation in front and back end sectors of the trade, competition amongst a large number of players will ensure better customer service and quality of products in addition to lower prices.

FRESH INVESTMENT IN THE SECTOR WOULD EASE THE CAPITAL CONSTRAINTS FACED BY MOST OF THE DOMESTIC PLAYERS AND THERE IS A POSSIBILITY OF REDUCTION IN OVERALL COST OF CAPITAL

Retail industry in India, like in any other market, needs strong back end support from efficient business partners such as third-party logistics, distribution, wholesale services and supply chain management solutions. Some of these service sectors are just beginning to develop in India. The permission for foreign investment in a phased manner will help in addressing the technology and experience gap that the industry is facing currently.

The impact of big foreign retail players on the domestic unorganized players would be positive. In fact, it is likely that these unorganized players would move to a higher

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equilibrium level of efficiency in a medium to long term horizon. Since we expect robust GDP growth as projected in the 12th five year plan, the inefficient unorganized players are likely to be pushed out of retail market and get absorbed in other economic sectors. There will be teething problems initially, but in the mid to long term horizon foreign participation will reap benefits for the Indian retail sector.

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