

India's Growing Consumer Product and Retail Market

Taking on a Life of Its Own

India's top petrochemicals and non-retail conglomerate, Reliance Industries Ltd., announced in June of this year that it would invest \$5.6 billion in the Indian retail market through a new subsidiary, Reliance Retail, in everything from food to clothes and travel services in a mixture of convenience stores, supermarkets and hypermarkets around the country, as well as in distribution centers aimed at connecting farm with retail (Reliance has also been in discussions with Target and Home Depot of the U.S.). This represents nearly 20% of the company's market value symbolizing the significance of India's burgeoning consumer market.

The other indicator of the growing attractiveness of India's consume market was the recent sojourn by the CEO of Wal-Mart International to India to meet with government officials, including Prime Minister Singh, in the hopes of persuading them to lift the ban on foreign direct investment by multi-purpose retailers in India.

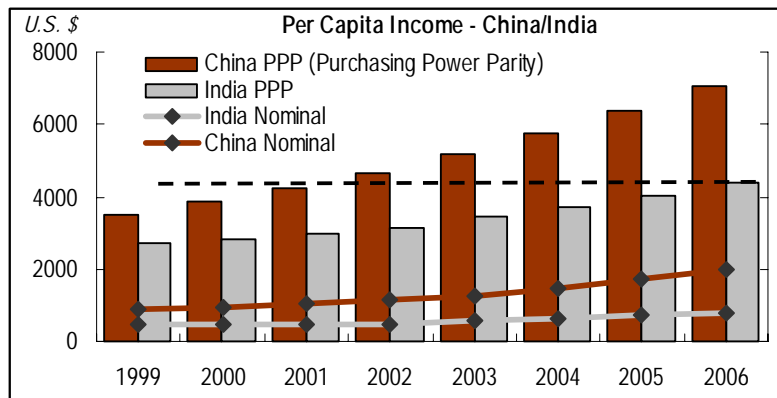
Income Growth Spurs Consumer Spending

India ranked number one in A.T. Kearney's Global Retail Development Index in both 2005 and 2006 for the consumer market's potential and attractiveness. The gist of the index is that a retailer is thinking about entering the Indian retail market now is the time to do it.

A.T. Kearney's 2006 Global Retail Development Index			A.T. Kearney's 2005 Global Retail Development Index		
		GRDI Score			GRDI Score
1	India	100	1	India	100
2	Russia	85	2	Russia	99
3	Vietnam	84	3	Ukraine	87
4	Ukraine	83	4	China	83
5	China	82	5	Slovenia	82
6	Chile	71	6	Latvia	81
7	Latvia	69	7	Latvia	80
8	Slovenia	68	8	Vietnam	79
9	Croatia	67	9	Turkey	78
10	Turkey	66	10	Slovakia	77
11	Tunisia	65	11	Chile	76
12	Thailand	64	12	Thailand	75
13	South Korea	63	13	Bulgaria	73
14	Malaysia	62	14	South Korea	72
15	Macedonia	61	15	Tunisia	71

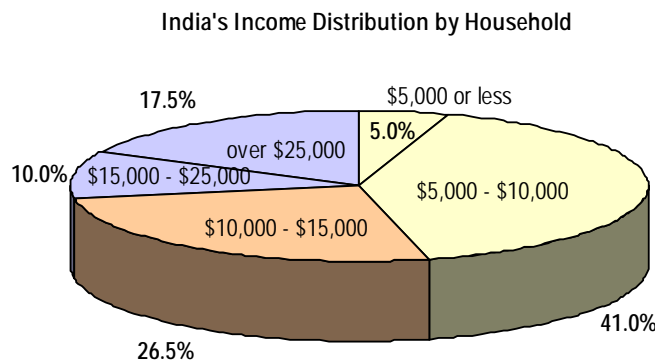
Based on weighted averages in 4 categories: Country risk, market attractiveness, market saturation and time pressure.

Fueled by a GDP growth rate that has averaged slightly over 6% over the last a 15 years, second only to China's, and expected to reach 8% in 2006, per capita income on a purchasing power parity basis (PPP) has risen 70% since 1998 to around \$4,360 (\$877 on a non-PPP basis), roughly the same as China's was in 2001 (currently \$7,044), and is expected to roughly double by 2014.



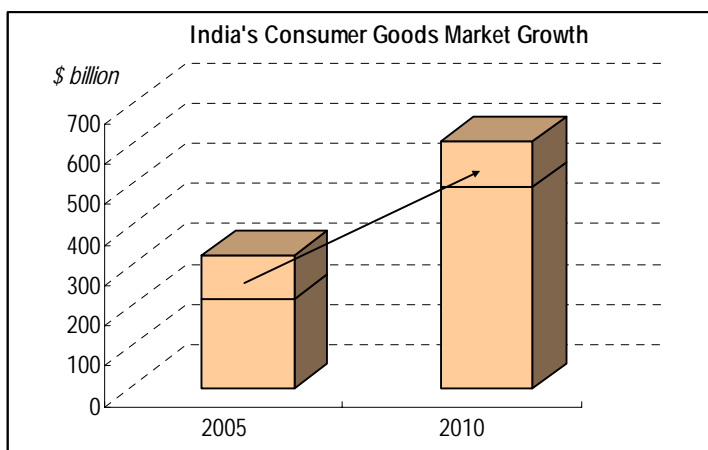
Source: Global Insight

It is estimated that these rising incomes have led to the development of a middle class population of some 300 million, roughly the population of the U.S., although we find this figure a bit too optimistic and would counter that with a figure of around 200 million, based on 17.5% of Indian households with incomes over \$25,000 on a purchasing power parity basis. This is still nearly as large as the 4th most populous country on earth (Indonesia). Furthermore, another approximately 10% of households are right at or just below the middle class line, with annual PPP incomes between \$15,000 and \$25,000 representing another 100 million consumers.



Source: World Resources Institute

These income demographics are powering retail sales in the consumer goods market which has been growing at more than 16% per year since 2003 with discretionary consumer spending (other than food) growing at nearly 10% a year since the late 1990s. While estimates vary on the current size of the consumer goods market, anywhere from \$220 billion by the Confederation of Indian Industry to \$350 billion by A.T. Kearney, it is forecasted that the market will nearly double by 2010 to anywhere between \$440 billion to just over \$600 billion, making it the fourth largest in the world. Furthermore, India's total real consumption growth is now outpacing China's for the first time in almost 20 years, having reached 8% in 2005.



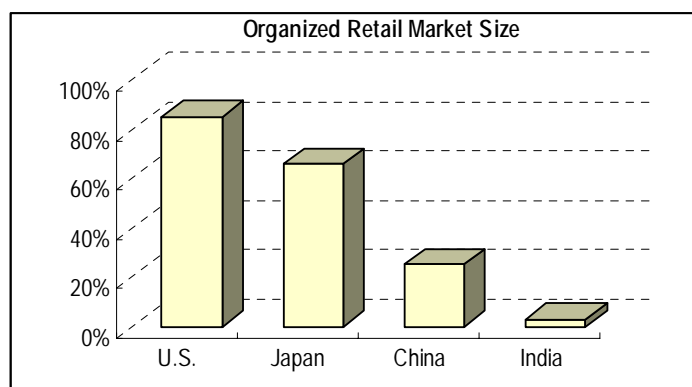
Sources: A.T. Kearney, Confederation of Indian Industry, others

The Attractive Organized Retail Market

These figures, combined with the fact that nearly 80% of India's population is under the age of 45, 54% under the age of 25, and that only a little over 3% of the consumer market is made up of organized retailing, has perked the interest of such global multi-brand retailers as Wal-Mart of the U.S., Carrefour of France and Tesco of the U.K.(planning to enter the market in a JV with Home Care Retail Mart in a smaller hypermarket format called Magnet), just to name a few, and is or has been targeted by some of India's largest conglomerates, such as Tata, ITC, Raheja, Murugappa, Piramal and of course Reliance. Moreover, the top 5 retailers in India make up only 2% of the market, making for plenty of opportunity at this point. In fact it is expected that the top retailers in India could capture as much as 10% or even more of the market by 2010. However, retailers will have to move fast as it is said that the Indian retail market is at a peaking stage, where the market is developing quickly and becoming modern. Saturation levels are usually reached within 5 years of this stage.

The current size of the organized retail market in India is only somewhere between \$6 and \$8 billion, however, it is growing at between 20% and 30% a year much at the expense of the unorganized market made up of family-owned mom and pop businesses which make up about 97% of the consumer market and make for a very fragmented and chaotic retail industry. There are about 5 million (some estimates go as high as 100 million) retail establishments in India which means there are about 22 per 1,000 people with an average floor space of less than 50 square meters.

To put this into perspective, Japan, one of the most densely populated countries in the world, has about 10 stores per 1000 people (the U.S. has 3.8) with an average floor space of 110 square meters, more than double India's. Additionally, in Japan, which has had a history of protecting mom and pop stores, organized retail (stores with 10+ employees) makes up about 66% of the market in value terms, in the U.S. it is 85%, and even in China's it is more than 20%. This potential organized retail market is what is making the Indian retail market so attractive.



Sources: U.S. Census Bureau, Japan Census Book, KPMG

Investment in Retail Soaring

As such, investment in the Indian retail market is expected to reach \$450 million over the next year or so and may reach \$4.5 billion by 2010. This push by organized retail in the Indian market can already be seen in the fact that there was but one shopping mall in India in 2001, but over 100 in 2005, with another 150 to 200 expected to come on-line by 2008. In 2004 there were about 100 department stores in India led by Shoppers Stop, a Raheja Group subsidiary, but the number has been growing 24% per year and is expected to reach over 300 by 2008.

Large supermarkets and hypermarkets have also been growing. FoodWorld, originally a joint venture between the RPG Group of India and Dairy Farm International of Hong Kong, grew into a 96 store chain of large supermarkets (since split up between the two with RPG's supermarkets operating under the Spencer brand name the same as their hypermarkets) and had been recording 30% annual growth, and Food Bazaar, a division of India's largest retailer

Some Expected New Investment in Indian Retail	
	2005-2008
Shopping Malls	150-200
Large Supermarkets	1,500
Department Stores	200
Hypermarkets	35

Pantaloon Retail, started in 2002 and with 43 large supermarket outlets as of 2006, growing at about 10 per year. Hypercity Retail, also a subsidiary of Raheja, plans to build 55 hypermarkets by 2015. In all, 35 hypermarkets and another 1,500 supermarkets are expected to be built by 2008.

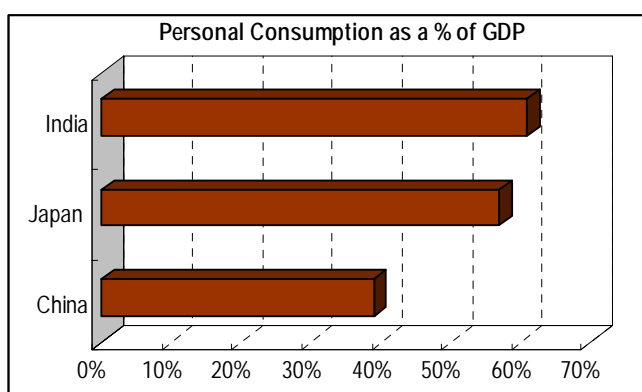
Specialized stores in a variety of consumer goods including consumer durables (Vijay Sales and Viveks, which has 52 outlets selling consumer electronics and appliances), books (Crossword, owned partially by Shopper's Stop), household furnishings, DIY and health care and beauty are rapidly developing. Manufacturers are also rapidly developing retail outlets, for example India's largest PC maker now has 200 retail outlets. Thousand of outlets of this nature are expected to open over the next few years.

India's Consumer Outlays

This development is a reflection of the growth in the consumer goods market in general. Just between 2003 and 2004 spending on consumer durables or white goods grew 53% and is expected to grow 12% in 2006. Spending on mobile phones grew 96% between 2003 and 2004 and has more than tripled in the last 3 years. India is now the fastest growing mobile phone market in the world. Passenger car sales grew about 25% annually and computers and peripherals over 10% between 2003 and 2005. Additionally, consumer spending on books and music and vacations was up 32% and home textiles up 29% in the 2003-2004 time frame.

White goods, autos and computers are all expected to maintain 10% plus growth through 2006. And the fast moving consumer goods sector, or FMCG, which constitutes such items as food and groceries, household and personal care products, confectionery and tobacco, among others, and makes up the bulk of consumer spending in India (over 70% of total consumption) grew about 6.5% in 2005 and is expected to be 8.5% in 2006.

Grocery spending, or spending on basic food needs, is currently only about 40% of consumer



spending in India, or on a par with China's 38%. However, India's personal consumption is 61% of GDP, while China's is still only 39%. Even Japan's is lower at 57%. (Basically, India has a more consumption driven economic model than either Japan or China.) Furthermore, the mortgage market has been growing 29% a year compounded and the credit card market by 35%, which may reflect a more stable

Source: IMF International Financial Statistics

financial system than China's. By some accounts, Indians are spending up to 40% of their discretionary income on lifestyle products and may be willing to borrow to do so.

Foreign Retailers - Indirect Access

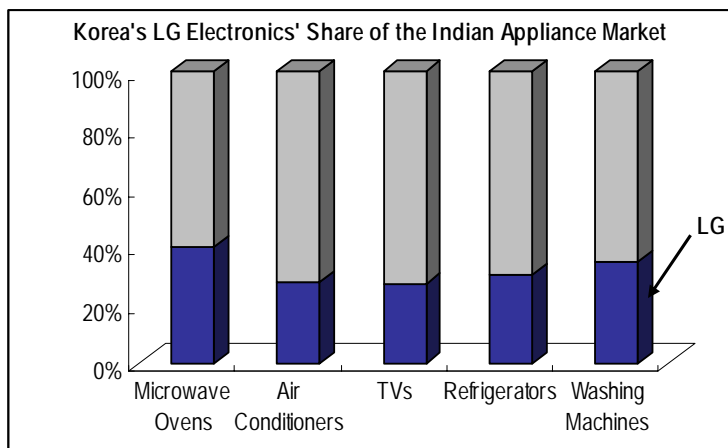
So where are the foreign retailers in all of this? Despite ongoing deregulatory reform in the Indian economy foreign direct investment is still not allowed in the retail market (except for a brief period in the 1990s). This does not mean though, there are not other, indirect avenues for access. Basically, there are four ways for foreign consumer brands to access India's market, franchising, wholesaling, licensing or by having a manufacturing base in India.

Such global brands as Pizza Hut, McDonalds, Adidas, Nike, Benetton, Marks and Spencer, Baskin and Robbins and Dominos are but a few who have chosen the franchising route, many of them in joint ventures with Indian firms. These companies are now well-positioned though, as the Indian government in early 2006 announced it will allow 51% ownership in JVs by single brand companies in the retail market. Already single brand companies like Gap, Zara, Timex and Starbucks have announced plans to enter the market.

In wholesaling, where 100% foreign investment is allowed, Metro of Germany, Shoprite of South Africa and Itochu of Japan have set up cash and carry wholesaling operations which entail the building of distribution infrastructure to assist local manufacturers. The move has not been without pitfalls as Metro was sued by local merchants saying that they were also catering to the retail market. Wal-Mart has been thinking about entering through this route with its own Sam's Club wholesale operations.

Most foreign brands, Gucci, Disney, Liz Claiborne and Rolex, to name just a few, have entered the market through licensing agreements. Just one recent example is the Tommy Hilfiger brand which entered the Indian market in a joint venture licensing agreement with the Murjani and Lalbhai (Arvind Brands) Groups of India.

As 100% foreign equity participation is permitted in manufacturing in India the production of consumer durables and other consumer products allows for direct sales in India. One successful example is LG Electronics of Korea, which entered India in 1997. The company



now has 25-30% of the market in India for air-conditioning units for homes, 27% of the color television market, 35% in washing machines, 30% in refrigerators and 40% in microwaves. It has been competing against Whirlpool of the U.S. and Samsung of Korea as well as such India makers as Godrej and IFB. If this wasn't enough Toshiba has just announced its entry into the market as well.

Source: *The Economist* (June 3-9, 2006)

Nokia of Finland, now has over 40% of the urban mobile phone market, however the market is really heating up with most of the major foreign makers (Samsung, Motorola, etc.) going head-to-head with some of India's most famous corporate names (Tata, Reliance, etc.) And in the all important fast moving consumers goods market Hindustan Lever, a Unilever (Anglo-Dutch) joint venture, is India's largest FMGC, while Nestle India, Colgate-Palmolive India and P&G are all big players in the industry, along with such Indian companies as Dabur, Godrej Consumer and Marico, to name a few. And of course the automobile industry is represented by most major auto makers, with Toyota and BMW announcing new recent investments. .

The current hope in India's retail market is that FDI barriers in retailing will soon be lifted, possibly within the next year or so. The Indian government's thinking is that the investment will help improve infrastructure and modernize supply chains, already the likes of Wal-Mart, Gap, Tesco and others have huge sourcing operations in India, and that the Indian consumer market will be so big that the foreign giants will be needed to meet the consumers needs. On the other hand, they may remove the barrier in phases, over a few or so years, in order to give Indian retailers a bigger jump on their foreign rivals than they already have.

Rural and Urban

However, with 85% of organized retailing taking place in India's urban areas, 66% taking place in India's 6 main cities alone, and with nearly all new mall development and hypermarkets aimed at these cities competition in these markets could become fierce. Already the retail focus is shifting to India's 61 second tier cities with populations of 500,000 or more.

Additionally, rural areas with approximately 700 million Indians representing 58% of India's disposable income and 40% of the middle and near-middle class are increasingly becoming targeted by organized retailing and large consumer product companies, Hindustan Lever, Coca-Cola and Reliance quickly come to mind. The rural market for FMCG is growing, while not quite as fast, nearly as fast as its urban counterpart. The rural market accounts for half the total market in India for fans, pressure cookers, bicycles, soap, tea, toothpowder and motorcycles. Also, the income gap between rural and urban areas in India is actually shrinking, for every \$100 earned in 1990 urbanites made \$82 more. That recently shrunk to \$56.

Hurdles Remain, but Still a Bright Market

There are many hurdles in the Indian market. India is still very poor with between 50% and 70% of the population living on less than \$2 a day (\$11 PPP), with rural incomes overall much lower than their urban counterparts. The country's GDP needs to grow 8%-10% a year to lift the population out of poverty. Reform in the agricultural sector, which makes up about 22% of India's GDP but employs more than 60% of India's workforce, is badly needed. Although India's agricultural industry has competitive advantages, remnants of socialist policies have encouraged a continuation of peasant farming. Furthermore, infrastructure in rural India remains poor with about 70% of the roads without 2 lanes and/or not paved making logistics a nightmare for retailers and distributors. Due to these distribution distortions Indian farmers receive only 20% to 30%, and in many cases less, of the retail price of fruits and vegetables compared to 40% to 50% in the U.S.

India is also diversified country both ethnically and culturally, giving the local unorganized sector and Indian organized retailers' distinct advantages over foreign retailers. If that wasn't enough India is also a democracy, one in which local regions, or states, have a great deal of autonomy, not unlike states in the U.S. This will give the local unorganized sector additional political clout in terms of competition, not unlike Japan and the Large Scale Retail Law that served to protect Japan's small retailers from the 1970s until recent times.

The Indian consumer market is basically in its infancy. The organized retail sector (not manufacturing) is still fundamentally dominated by Indian companies either alone or through joint ventures. However, if FDI continues to increase (50% rise in 2005), and the service sector, especially in the outsourcing and IT areas, maintains its growth trajectory, India could have a middle income consumer class of between 400 and 600 million in the not too distant future. This combined with \$135 billion earmarked for infrastructure development could make India an attractive destination for consumer and retail related investment and is why Wal-Mart, Carrefour, Tesco and numerous other retailers and consumer goods companies are currently scrambling and looking for partners and ways to enter the Indian market. It could make for a lot of intriguing combinations.

Interestingly, market pressures from India's burgeoning consumer class and their growing demand have already started to spur agricultural reform and increased investment in India's "farm to retail" field by the private sector (Bharti Enterprises, through its subsidiary FieldFresh, has already entered the field and Reliance has plans to). It seems that India's growing consumer market might be taking on a life of its own.

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