



Setting up shop

Despite a restrictive regulatory regime and deep political sensitivities, now is the time for foreign retailers to establish a foothold in India

Ben Frumin in New Delhi explains

Against the colossal backdrop of a Bollywood film poster stand a group of college students tucking into McAlloo Tikki burgers, one of McDonald's attempts to capture a distinctive local flavour that will appeal to its wealthy clients. And McDonald's is far from the only retail outfit vying for a share of the affluent Indian consumer's disposable income. Numerous international retailers including Starbucks, Tesco and Ikea have also expressed a keen interest in expanding into the Indian market.

According to the Associated Chambers of Commerce and Industry of India (ASSOCHAM), the country's retail sector is growing by as much as 28% a year. In 2007 the industry was worth US\$300 billion and it is expected to rise to US\$365 billion this year and US\$440 billion by 2010. And still, about 95% of India's retail sector remains unorganized, mostly comprising of small, cluttered neighbourhood shops and street vendors that aren't even registered for sales and income taxes.

But organized retail is growing fast, from one million square feet in 2002 to nearly 14 million square feet last year, according to ASSOCHAM, and with it, opportunities for foreign investors. "With [the] involvement of big corporate houses and a liberalized FDI policy, this sector is being gradually organized and therefore considered a lucrative investment possibility for foreign companies," says Sunaina Kapoor of PSA Legal, a law firm in New Delhi.

Understanding India's complex retail industry, however, is no easy task.

"The retail market in India is very, very different from the retail market anywhere else in the world," says Srinivas Parthasarathy, a partner at Allen & Overy in Singapore.

"India is still a brave new world for most multinationals," explains Anthony Root, head of Milbank Tweed Hadley & McCloy's corporate practice in Asia. Root emphasizes the need for in-depth local knowledge, adding that "using western standards and western techniques just makes no sense".

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Anthony Root

Head of Corporate Practice, Asia
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A unique shopping experience

Until recently, India was a country of savers rather than spenders. Its consumer culture was dominated by small, unorganized family-run shops selling little more than essentials (the country's first indoor shopping mall was



MARKET DOMINANCE: Neighbourhood stalls and street vendors control 95% of Indian retail.

built barely a decade ago in Mumbai). But as India's economy continues to grow at a fantastic rate – a 2007 report by McKinsey & Co predicts that Indian incomes will nearly triple by 2025 – many of the country's upper and middle class consumers are no longer content with limiting their shopping to the neighbourhood fruit cart and cramped corner stores. Nor do they want to elbow their way through dirty, crowded outdoor markets.

According to Shilpa Malik, vice president of business development for Select Infrastructure, which developed and manages Select Citywalk, one of India's newest and most lauded malls, the target consumer for the new Indian retail market is a brand-conscious, world-travelling urban Indian woman who knows "the collection Marks & Spencer is carrying in the UK this season and if the same collection [in India] is dated". The new Indian consumer is "comfortable pub-hopping and having vodkas in short black dresses," she adds.

Malik believes that targeting this sort of consumer is the key to success in the new Indian retail market: "If you capture the woman, you capture the household," she says. But successfully connecting with this rapidly changing Indian consumer is far from easy for large retailers, and restrictive regulations remain one of the most significant stumbling blocks.

Gaining access

Until just a couple of years ago, foreign direct investment (FDI) in retail was essentially prohibited in India. It remains an extremely controversial issue (see *Shopping: a politically charged activity* on page 18), but a major policy change in February 2006 allowed FDI of up to 51% in single-brand retail.

Products are required to be of a single brand, sold under the same brand globally, and must be branded during manufacturing. However, single-brand FDI retailers like Nike or Reebok must still obtain government approvals before they are permitted to set up shop.

According to Anirudh Mukherjee of Mumbai-based law firm Economic Laws Practice, the first step in establishing a single-brand retail operation is to seek permission from the Secretariat for Industrial Assistance in the Department of Industrial Policy and Promotion (DIPP). Applicants should specifically indicate which product or product categories they propose to sell under a single brand.

"While indicating the product categories, the foreign company must be careful, as any addition to the same would require fresh government approval," Mukherjee warns.

Once the application is processed by the DIPP, it moves forward to the Foreign Investment Promotion Board (FIPB) for final approval. "As long as the applications are within the existing guidelines, the FIPB clearance is a formality," says Jayant Bhuyan, CEO of the India Brand Equity Foundation and deputy director general of the Confederation of Indian Industry.

Typically, this process takes six to eight weeks, explains Anubhuti Agrawal, an associate at Amarchand Mangaldas, emphasizing that the government wants the procedure to be viewed as straightforward, simple and fair.

Once the approvals are in hand, Agrawal says it often takes just two or three months for a single-brand retailer to open shop. Brands that have successfully completed this procedure include Diesel, Hermes, and Nike, among many others.

Mukherjee notes that further liberalizations could be in store for this slice of the retail sector: "In relation to single-brand retail where FDI up to 51% is allowed, the government is still undecided as to whether the remaining 49% may be held by foreign institutional investors," he says. "This aspect of FDI in single-brand retail is presently under governmental consideration."

Franchising and wholesale

There's also the franchise route, which was particularly popular before FDI in single-brand retail was allowed. Many upscale foreign-brand shops at five-star hotels and popular international stores like United Colors of Benetton and Nine West are franchises in which the foreign entity has entered the Indian market by allowing a local franchisee to

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Partner
Allen & Overy



use the foreign investor's name and technical support in return for royalties.

In the case of technical collaborations, Mukherjee explains that the royalty paid to the foreign collaborator

Cash-and-carry: the Wal-Mart way

Like it or not, Wal-Mart is coming to India. But the retail giant won't be setting up the air-conditioned, consumer-friendly superstores visible in so many other countries. Instead, in order to comply with Indian laws, Wal-Mart is establishing with Bharti Enterprises a business-to-business wholesale retailing company called Bharti Wal-Mart. The venture is a 50-50 joint venture between the two companies, though Indian law would have allowed Wal-Mart 100% FDI in such a back-end business.

"It is a joint venture out of choice, not compulsion," a Wal-Mart spokesman tells *India Business Law Journal*. "We recognize the importance of having a local partner based on our excellent experiences working with partners around the world in places like Mexico, Central America and China."

"Bharti is a great company," the spokesman continues, "with a strong understanding of the market in India, and makes for a winning partnership."

Wal-Mart sees the potential for its wholesale cash-and-carry business in India as immense, and is eyeing the country's 12 million neighbourhood shops – 90% of which the company says are not directly served by fast moving consumer goods companies – as its customers.

"Our B2B wholesale cash-and-carry stores, which we are initially targeting to open in tier II and tier III cities, will offer a great way for *kirana* stores to get access to quality products at the prices they need," explains the Wal-Mart spokesman. "In turn, they can pass on these benefits to their customers."

There are many who believe, however, that Wal-Mart is less interested in wholesaling its goods to *kirana* shops and more focused on doing business with one particular retail chain: Bharti Retail. *Mint* reported on 17 April that Bharti Retail had quietly opened its first three grocery stores in Ludhiana, Punjab, speculating that the low-key opening might have been motivated by a desire to avoid protests. Bharti Retail has entered a franchise agreement with Wal-Mart, and will receive technical support from the American company – a relationship that some see as proof of Wal-Mart's intention to focus on selling to Bharti rather than wholesaling to *kirana* shops.

"Here Wal-Mart is coming as a wholesaler, and Wal-Mart is only selling to Bharti. And Bharti is doing the retailing," says Dharmendra Kumar, director of India FDI Watch, adding that he thinks Wal-Mart has found a backdoor into India's retail market that, while compliant with the law, is perhaps incongruous with the law's intent.

And yet, as the Wal-Mart spokesman correctly points out, "this is completely in line with what is permitted under existing guidelines."

It's a set-up some lawyers suspect may be adopted by other foreign retailers with an eye on India. "I think Carrefour is also looking at the same thing," says Vineet Aneja at FoxMandal Little.

Carrefour would be retracing steps already taken by Metro AG of Germany and Shoprite Holdings of South Africa, which already have cash-and-carry operations of this nature in India.

It has become generally accepted, says one Indian lawyer, that this is the formula that works. "You have front-end retailing which was not open to the foreign party, and back-end retailing or wholesaling which was available. So you have to find inventive ways of getting structures that allow you to marry value between the two and ensure that the Indian partner does the front-end retailing."

Some wonder if Wal-Mart and Bharti have a hidden deal that will provide for restructuring if and when FDI is allowed in multi-brand retail. But such speculation remains publicly unsubstantiated.

"It's not traditional," Aneja says, noting that wholesalers or distributors do not typically trade with a single retail partner on the front end. And yet, Aneja underlines that the "Wal-Mart example is completely legitimate. They're doing the wholesale supplying and all the retail outlets are owned by Bharti."

Ketan Kothari of Thakker & Thakker explains the scenario to foreign investors: There are three layers in this sector, manufacturing, distribution and front-end retail. "The first two layers are open for you," he says. "And everybody who has functioned in these layers has survived in India."

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Anubhuti Agrawal

Associate

Amarchand Mangaldas



may not exceed 5% of domestic sales, and 8% for exports, while lump sum payments may not exceed US\$2 million. "Any royalty payments in excess of the above shall require prior approval of the central government," he warns.

Bhuyan points out that several upscale international retailers, Gucci, Marks & Spencer, and La Perla, among them, have already entered India through such franchise agreements with Indian partners. As the *Telegraph* recently reported, Marks & Spencer plans to open a further 50 stores in India through a joint venture with Reliance Industries. The partnership offers the foreign retailer a 51% stake in the company known as Marks & Spencer Reliance India, while Reliance Retail is given a

49% controlling interest.

Foreign companies are also permitted to test market products in India for a two-year period, by the end of which they must set up manufacturing facilities in India. As one lawyer notes, this mechanism allows foreign investors to get their feet wet in the Indian market without setting up a costly brick-and-mortar manufacturing presence.

Other retailers get into India through the backdoor. Under the automatic route, in which no prior government approval is necessary if the proper paperwork is filed, FDI of 100% is allowed in cash-and-carry wholesale trading. In what is easily the most talked-about use of this provision, Bharti Enterprises and Wal-Mart are establishing a wholesale cash-and-carry operation called Bharti Wal-Mart (see *Cash-and-carry: the Wal-Mart way* on page 15).

FDI of 100% is also permitted, according to Mukherjee, in trading companies engaged in exports, bulk imports, and the trading of high-tech, medical and diagnostic items, or products requiring specialized after-sales service. The same applies to business-to-business e-commerce activities and, subject to FIPB approval, companies trading items sourced from the small-scale sector but manufactured with technology provided by the foreign collaborator.

Multi-brand retail: the elusive prize

Despite the liberalizations of 2006, multi-brand retail remains strictly off limits to foreign investors. And in spite of fierce debate at the highest levels of government, few in the legal profession believe that liberalization will come any time soon.

Kapoor at PSA Legal notes that the Ministry of Commerce does seem to be considering allowing FDI in multi-brand retail in some specific niches such as household appliances,



OPPORTUNITY ABOUNDS: Marks & Spencer plans to open 50 new stores in India in partnership with Reliance Industries.

professional, electronic and sporting goods. Like single-brand outlets, multi-brand stores in these niches are not expected to compete directly with local stores, often referred to as *kirana* shops. As a result, the government is unlikely to encounter the same resistance it would if it allowed foreign retailers like Wal-Mart and 7-Eleven unrestricted access to the Indian market.

“The main aim is that the neighbourhood shops should not be affected,” explains Agrawal.

But even limited reforms to FDI in multi-brand retail are likely to come with restrictions: “Such a proposal, if and when allowed, would only permit foreign retailers to enter the Indian market through joint ventures for multi-brand stores,” warns Mukherjee. Furthermore, “the said proposal would come with strict riders on the role and functioning of the foreign partner in running the Indian venture”.

For example, the foreign multi-brand retailer might only be allowed a small stake in the joint venture. There may also be curbs on the number of positions on the board that the foreign entity could hold, and the chairman’s seat could well be reserved for an Indian national. The foreign entity might not be allowed any special powers by way of board resolutions or articles of association, and government approval might be required before opening each additional store or amending the format of the joint venture.

“As nothing concrete has been laid down by the government in terms of their likely policy [with] respect to allowing FDI in multi-brand retail, it may be advisable for prospective investors to wait until a definitive policy decision is taken,” says Mukherjee.

“It is, perhaps, premature to suggest plans and possible structures to foreign investors looking to break into this sector as too little is known,” agrees Kapoor. But among the issues to be looked at, she says, are distribution infrastructure and costs associated with distribution, and variances in tax rates and credit provisions among Indian states.

Spoiled for choice

The jury is also still out on how the potential entry of foreign multi-brand retailers might affect the single-brand enterprises already in India. Some think these stores won’t be in direct competition, while others believe that the

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Jayant Bhuyan

CEO

India Brand Equity Foundation



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Anirudh Mukherjee

Economic Laws Practice



single-brand outlets may suffer in the face of unfair competition. Locally owned organized retailers like Reliance Fresh and Bharti’s recently opened Easy Day stores may also present a competitive threat to single brand retailers that trade in similar goods.

“Single-brand retail outlets will face severe competition,” Mukherjee says. “A multi-brand outlet gives customers options to pick and choose from an array of products and it gives them the scope to go for a comparative appraisal with other brands on offer.”

“The opening of FDI in multi-brand retail will make these single-brand units alter their business model, and these products will also be available on the shelves of multi-brand retail shops besides their own exclusive outlets,” says Vijaya Sampath, group general counsel and company secretary at Bharti.

Particularly threatened may be single-brand retailers like Nike and Adidas, Mukherjee posits, because multi-brand footwear retailers may be among the first allowed to set up shop in India.

Baby steps

“There is no single optimal way for foreign retailers to do business in India. A number of models can be tried,” says Bhuyan.

But there’s also a consensus among many that since major changes to FDI regulations for multi-brand retail aren’t imminent, foreign retailers may want to start off with a small, immediate presence in the country that they can scale up as and when changes to the law allow.

“Start with baby steps,” says Ketan Kothari at Thakker & Thakker, a law firm in Mumbai, “and then go full floor.”

“Since the start-up costs are lower, and it is easier to scale up under the franchise route, a number of international brands have done surveys in India for starting these outlets,” says Bhuyan, adding that “it is widely acknowledged that this is no more than a stopgap arrangement till multi-brand retailing is formally allowed.”

Others suggest that it’s wise to start with a limited number of outlets, perhaps in cities like Chandigarh or Jaipur, where opportunity is plenty but growing pains won’t be magnified the same way they would be in Delhi

Shopping: a politically charged activity

The issue of FDI in retail, and multi-brand retail in particular, is one that is fiercely political and hugely controversial. "Just like any controversy in India, it's complicated," says Srinivas Parthasarathy, a partner with Allen & Overy in Singapore.

Major global retailers are eager to break into this exploding sector of the Indian economy, but opponents worry about the effect this would have on local stores which are often small, cramped, friendly and family-run, with a somewhat unreliable inventory and a tight layout that can make consumer browsing difficult.

Opponents of FDI in multi-brand retail believe that foreign retail powerhouses would crush millions of *kirana* shops and street vendors that still make up the huge majority of India's retail sector, while providing negligible benefits to consumers. "Such companies will, with their incredibly deep pockets, be able to sustain losses for many years till their immediate competition is wiped out," says Anirudh Mukherjee of Economic Laws Practice. "This is a normal predatory strategy used by large players to drive out small and dispersed competition. This entails job losses by the millions."

"Presently," Mukherjee continues, "the popular sentiment seems to be that allowing the entry of foreign players will most definitely disrupt the current balance of the economy and render millions of small retailers jobless by closing the small slit of opportunity still available to them."

Social activist Dharmendra Kumar uses more dire and immediate language: "The local economy is getting destroyed," he says. "The worst is already happening."

Wal-Mart claims its venture will actually benefit *kiranas* by giving them quality merchandise at competitive wholesale prices, while increasing supply-chain efficiency and minimizing waste (see *Cash-and-carry: the Wal-Mart way* on page 15).

"The venture will support farmers and small manufacturers who have limited infrastructure and distribution strength, and the supply chain will enable minimum wastage, particularly of fresh foods and vegetables," says Wal-Mart's spokesman. "The objective is to cut the waste, not the middlemen who can play a very important part in the entire supply chain."

There are also those who say that the concerns of opponents are exaggerated. "It is going to have some effect, but not as much as what is being projected," says Vineet Aneja at FoxMandal Little. "It's not going to run everybody out of business."

Still, Kumar, the director of India FDI Watch, continues his three-year-old national campaign against FDI in multi-brand retail. He has organized a loose coalition of labour unions, trade associations, NGOs, shopkeepers, vendors, farmers and manufacturers to put pressure on the government. There are literally tens of millions of Indians who have a direct financial interest in keeping the country's retail sector unorganized, and movements like Kumar's have proven to have significant political power.

"It appears that concerns of the negative impact on small family business will have to be addressed by the government even in the absence of FDI in retail trading,"

says one lawyer, "and such concerns may therefore not relate solely to a decision on whether FDI should be allowed in retail trading."

Kumar recognizes that foreign retailers are far from the only threat to unorganized retail in India. Large domestic industrial houses such as Reliance, Tata and Bharti have already made significant inroads, leaving the controversy a bit muddier than foreign corporations versus local shopkeepers. "This is not a debate between organized or unorganized, or traditional versus modern, or big versus small, or foreign or domestic," he says. "We see it as a question of corporations versus people."

Even domestic corporations may be rethinking their retail strategies as a result of grassroots opposition movements like Kumar's. "Indian retail giants like the Mukesh Ambani-owned Reliance Group have had to shut their green grocery and provision stores in states like Uttar Pradesh because of protests from local trader groups and political parties," says Jayant Bhuyan, CEO of India Brand Equity Foundation and deputy director general of the Confederation of Indian Industry. "This is clearly an issue on which the government will have to tread cautiously."

Kumar believes that retailers in India ought to disavow the corporate path and ideally follow the model of dairy cooperatives like Amul and Mother Dairy so that everyone working in the retail sector would be a stakeholder. Kumar argues further that corporate retail outfits in India should sell goods that are at least 90% locally sourced.

That particular concern is something of a red herring, according to some lawyers. "The fear that you're going to have loads and loads of foreign goods coming in is inaccurate," says one lawyer. "It makes no economic [sense] to import a whole lot of goods to India to sell at Indian prices."

"Political parties may not want to rock the boat in terms of trying to push through something very aggressive," says Ketan Kothari of Thakker & Thakker in Bombay, adding that with a highly contested national election expected no later than next year, "the window, right now, is shut."

Some lawyers, both in India and internationally, muse that if either Congress or the BJP claimed a big win in the next election, FDI in multi-brand retail might have a better shot than it does in a fractured coalition like the current government. "Maybe a lot more could have come up on the horizon had the government not been so dependent on the left for its survival," Kothari says.

"If the Left is involved with any manner of the new government, I think you can forget about the laws changing in a hurry," warns Parthasarathy.

In the meantime, activists like Kumar will continue to vigorously oppose the entry into India's retail market of corporate giants who may wipe out small neighbourhood shops. Regardless of where people stand on this issue, most agree that the bubbling controversy is enough to quell any immediate liberalization of FDI in multi-brand retail.

As Kumar says, "I don't believe that this government will be so foolish."

or Mumbai. For instance, Bill Rattazzi, CEO of Emaar MGF, a joint venture between Emaar of Dubai and Indian giant MGF, says his company plans to develop malls in 20 different Indian cities, including Calcutta, Lucknow, Amritsar, and Mohali.

“Seeing the potential for the retail sector, foreign investors should consider aligning themselves with domestic partners, assessing the distribution chains, scouting for locations, analyzing the difference in the regional markets of India, and the effect that has on products and pricing,” says Michael McNeill, a partner at Baker & McKenzie Wong & Leow.

Jo Hall, the managing director of Woolworths in Asia, shares similar sentiments. “Our view is that in developing markets it is best to work with experts rather than try and take on the proposition on your own. Operationally India has a lot of challenges that often mature markets would struggle to understand,” she explains.

Patience required

Despite the restrictions, many believe that the time is right for foreign retailers to establish a presence in India. Indeed, starting now and making the inevitable mistakes while the operation is still small is a smart step along the path to later grand-scale success.

“There is a significant amount of purchasing power which is getting generated at the burgeoning middle class level,” Kothari says, adding that “there is a huge market which is open for anyone to tap.”

It is, however, a market that may take quite a while to achieve its potential. When asked how long it will take for

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Michael McNeill

Partner

Baker & McKenzie Wong & Leow



India to start looking like Thailand, where it often seems every corner has a 7-Eleven – a natural competitor to *kirana* shops, and one that declined *India Business Law Journal's* invitation to comment – several lawyers say that situation will be a long time coming.

“My best guess would be that that would happen in the next 10 years,” says one Indian lawyer. “It’s difficult to foresee that happening any [sooner].”

Such are the timetables of retail strategies in India: long time, long term, long run.

But, as Kothari says, “in the long run, it’s a great market. There’s no doubt about it.” ■



SWEET DREAMS: Not all Indian retailers are having sleepless nights over foreign competition.