



# THE INDIAN RETAIL MARKET

By Devangshu Dutta

Devangshu Dutta is chief executive of Third Eyesight (website: [www.thirdeyesight.in](http://www.thirdeyesight.in)), a specialist consulting firm focussed on the retail and consumer products sector. Third Eyesight works with brand and market leaders with sales of over US\$ 80 billion, as well as small and start-up businesses.

Over the last few years India has had one of the highest GDP growth rates, across the world, and consistently. In the last two years, GDP growth is estimated to have been 9.6 per cent (2006-07) and 9 per cent (2007-08).

**A** combination of private and public investments in recent years, as well as steady liberalisation of regulations, has created a situation that is unique in India's history as an independent country, where business growth has led to individual prosperity which is, in turn, leading to explosive growth of further business opportunities. Although India's per capita income still places it in the list of "developing countries", a significant population has emerged that is truly middle-class.

Rising incomes have created visible shifts in consumption patterns. Certainly, more Indians regularly consume cereal flakes, processed cheese and fruit-



based drinks for breakfast than did ten years ago. A generation has grown to adulthood wrapped in ready-to-wear clothing (with visits to the tailor mainly for wedding trousseaux). And, yes, Indian consumers are increasingly welcoming modern retail environments over the traditional.

These economic developments have attracted the attention of both domestic and international consumer-goods companies and retailers, and several of these companies have seen annual growth rates 20-50 per cent in the current decade. Many of the new entrants into the retail sector are large business groups that have set up modern retail chains whose share, although still small, is growing year-on-year.

This growth of modern retailing is also having an impact on the processes and the infrastructure deployed for the retail sector. These businesses are run as true chains which require processes and systems similar to any chain-store business anywhere else in the world

including merchandising, sourcing, human resource management, logistics and store operations. These modern retail stores demand Grade-A buildings for shopping centres, with associated infrastructure and services within them.

Therefore this, in turn, has created a growing opportunity for companies that are manufacturers or vendors of consumer products, suppliers of other goods that are used within a retail business or companies providing services to the retail sector.

In the rush to grow, while challenges have been acknowledged, none of them have appeared seriously debilitating in the long term, until possibly now.

During the years 2003 through 2007, news headlines mainly focussed on joint-ventures or strategic alliances, new store openings, new format launches, and mega-investment plans. If human resources were mentioned, it was about the apparent domestic shortage, about the expatriate talent being pulled in, and about incredible salaries. If shopping centres and retail space was studied, it

was the phenomenal growth in square footage and the increasing scale of the new malls that was the focus.

Suddenly, however, the tide in the press seems to have turned. There's mention of "slow" growth plans of major retail joint ventures. There's whisperings and denials about lay-offs, accompanied by some high-visibility exits.

It would be tempting to read the signs as evidence that the previous growth was based on hype, which has run out of steam. It would be tempting, and it would also be too simplistic.

The fact is that macroeconomic factors are also acting as dampeners in 2008, and the year may be marked in the recent history of India's modern retail sector for the dawn of realism. Just as the growth of the retail sector was reaching into the not so profitable geographies and beginning to ride on not very efficient structures, economic growth has begun to slow down dramatically. From a 9 per cent-plus growth rate in previous years, a variety of agencies expect GDP to grow between 7.5 and 7.9 per cent in 2008-09. Further, the Prime Minister's Economic Advisory Council forecasts a GDP growth rate of 6.8 per cent in 2009-10.

What's more, 2006 and 2007 have

brought about phenomenal increases in two critical cost heads: real estate and human resource.

So on the one hand, retailers are facing dramatically higher operating costs, and on the other hand demand seems to be weaker than they have expected. For businesses that have been launched in the last 5-7 years, such a situation is completely new.

### ESTIMATING THE DEMAND – STILL AN ART?

Since the early years in the decade, most retail chains have grown quickly by identifying new sites and replicating existing successful business models and formats. Typically, the growth was limited in its geographic spread, and the underlying consumption pattern differences between the existing markets and the new locations were not stark enough to be immediately visible. Much of the growth, in fact, came from new stores in the larger cities, including the metros, mini-metros and the next tier markets.

This high replicability has allowed the businesses to rapidly scale up into becoming truly national chains, and the presence of modern retail formats has become visible among the larger cities and towns.

As the companies have begun to feel "saturated" in the larger cities, they have gradually moved towards the smaller towns, with their existing product-price-format offer tweaked slightly.

However, the ethnic, linguistic and cultural diversity of India's 28 states and seven Union Territories makes it less like any other single nation-state and more like a collection of countries such as the European Union. The result is sharp differences in income, tastes, habits, and culture, all of which present a challenge for consumer products and retail companies in terms of product and pricing mix.

Most European brands do not approach different markets within the EU with identical strategies. So why should we believe that the business formula that works in one part of India will work in exactly the same way in other parts?

A bigger issue is the realistic estimation of the target population. There are cases where the demand has been grossly overestimated, and the business infrastructure and investment plans are over-weighted by these expectations.

Estimates of 200-300 million middle class (50-60 million households) sound very attractive, but by what measure of income and spending standards?

Going by the pricing of many of the brands in the market today, it would be logical to use developed market income standards. If we use global income standards the middle class numbers are much smaller. The number



	India	European Union
Constituents	28 States, 7 Union Territories	27 Countries
Languages	22 (over 1,600 dialects)	23
Area	3,287,590 km <sup>2</sup>	4,324,782 km <sup>2</sup>
Population (est.)	1,132,446,000	497,198,740

of households earning truly middle class annual household incomes (not adjusted for Purchasing Power Parity), is less than 5 million.

Of course, the upside is that the growth rate in this income class is estimated to have been over 20% a year during the current decade and this group is forecast to comprise over 3.7 million households or about 20 million individuals by the end of the decade. There are few other markets in the world where the target population displays a growth of over 20% a year! Moreover, the annual growth rate of the incomes earned among this population is also the highest in the country. Further, a large proportion of this population is concentrated among the metropolises, as mentioned earlier.

So it is a nice market to be in, if the business plan is sized appropriately. You can expect some homogeneity based on the socio-economic classification, and the geographical reach is also limited, allowing for organic growth.

A specific challenge for companies wishing to enter with a “western” business model or product mix is that, even through its most controlled years, India has been a market economy (unlike China’s decades of a completely centrally controlled economy). Therefore, in most consumer products there are several domestic brands and Indian *avatars* of foreign brands available, even if the choice is narrower than on the shelves of western supermarkets. Competing offers are available, whether from Indian



companies or Indian subsidiaries of global consumer products companies. In that sense, India is not a virgin market. There is already some (or significant) amount of marketing noise and clutter, created by the existing competition.

It is vital, therefore, for any company to identify the true overlap between its offering and the most appropriate consumer segment(s) in India to assess the real short-term and mid-term potential for its retail business.

**THE URBAN RETAIL OPPORTUNITY AND CHALLENGE**

While we are on the subject of the cities, it is very pertinent to look at the spread of the urban population.

As India’s population moves increasingly into cities, it is the larger

cities (Class 1, with a population of over 100,000) that are growing the most. From 308 Class 1 towns, the number of Class 1 towns and cities in India had grown to 643 in the 2001 census, and are estimated to hold about three-quarters of the urban population.

These cities are also economic magnets. No matter how attractive the new boomtowns may sound, the larger cities still pull in huge numbers of immigrants from the smaller cities, towns and villages, keeping the ecosystem vibrant.

Within these, in terms of economic potential for retail businesses, it is the tier I cities (metros and mini-metros) that are the still unmatched. In 2001, the top eight cities were estimated to have 40 per cent of the urban disposable income, and despite rising costs and rising competition these remain the most attractive market for a company looking to establish a new retail business. In socio-economic terms there is more homogeneity available to a brand wishing to tap into a critical mass of customers, discretionary incomes are higher (in absolute not just percentage terms), and the infrastructure available to service the consumer is better.

Of course, the side effects of the population overloading are now visible,

**Estimated Growth of Major Metropolitan Centres**

Estimated Population of Major Conurbations (million)	1991	2001	2005
Greater Mumbai	12.6	16.4	19.9
Delhi (National Capital Region)	8.4	12.8	19.7
Kolkata	11.0	13.2	15.7
Chennai	5.4	6.4	7.6
Bangalore	4.1	5.7	7.1
Hyderabad	4.3	5.5	6.7

Sources: Various

## While households in cities such as Chandigarh and Ludhiana have high surplus incomes compared to Megacities, their much smaller populations force marketers to treat them as niche markets.

ever more, on the cities' infrastructure and governance. And some of the overloading is contributed by the development of shopping centre space.

The growth of modern retail has brought with it a rapid expansion in shopping centre space. This is both an opportunity and a challenge.

While the extraordinary growth of shopping centres has provided more space for brands and modern retailers to grow their business, much of the growth has been concentrated in the metropolises.

Almost half the shopping centre space by the end of 2007 is estimated to have come up in the conurbations of Mumbai and Delhi. This "over-shopping" could potentially lead to the failure of a significant number of these malls. The failure may not result in outright closure – the better sites may change ownership, while others might get repurposed as office blocks or other commercial projects – but it will be painful, nevertheless.

Paradoxically, despite the proliferation of malls, for retailers and brands high real estate rental costs are the possibly the biggest headache. In many instances, brands have signed-on high-rent shops with the aim of balancing their portfolio over time, and fully expect these shops not to make money in the foreseeable future.

Further, the intensive development of malls, without adequate zoning and planning of support infrastructure such as roads and public transportation is now stressing not just the city, but the malls themselves. Even if there is adequate parking space within the mall (as compared to a few years ago), what

good is it if a two kilometre stretch of road before the mall is choked with traffic moving at 2-3 kilometres an hour? The convenience of shopping under one roof is totally outweighed by the inconvenience of spending thrice the amount of time on the road, and is a critical deterrent to a serious shopper who is being targeted by the tenants of the shopping mall.

### TIER 2 AND 3 CITIES – A WORK IN PROGRESS

A recent study by NCAER and Future Capital Research compared 20 cities, and classified them into the Megacities (metros and mini-metros), Boomtowns and Niche Cities. The naming of these groups is quite telling.

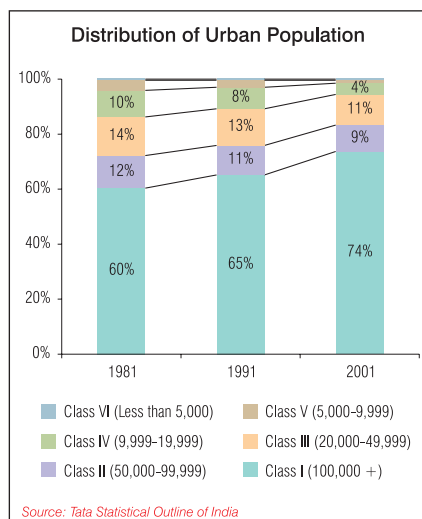
Megacities on this list include Mumbai, Delhi, Kolkata, Chennai, Bangalore, Hyderabad, Ahmedabad and Pune, and have approximately 50% of their income as surplus after

household expenses (other than Kolkata and Pune which show surpluses in the 30s). They have large populations, and combined with the surpluses, this up to a massive economic opportunity.

However, the smaller cities have been developing into economic hubs in their own right. If population is a key factor, then Surat would be classified as a metro. It has a high average household income, as well as a high surplus. Similarly, Nagpur, with its logistically important location is also developing into an important market. Along with Lucknow and Jaipur, households in these cities have seen double-digit booms in terms of income growth since 2005, a trend also seen in the Megacities.

This trend of income growth, infrastructure development, trickling of business hubs into the 2nd and 3rd tier cities, will continue to broaden the base of modern retail and distribution further outside of the major cities. On the other hand, while households in cities such as Chandigarh and Ludhiana have high surplus incomes comparable to the Megacities, the much smaller base of population would force marketers to treat them as niche markets until a critical mass develops over the next few years.





Thus, while much has been made about the boom in the smaller cities and towns, the formulaic approach of rolling out the same business model will certainly not work.

The signs of overestimation of demand in Tier-3 and Tier-4 cities is visible in instances of downsizing of store-space by prominent retailers, as well as relocation or closure of some of the new stores which have not performed to expectation.

**THE TUG OF WAR TO MODERNISE RETAIL**

**In my opinion retail is fundamentally an organic business.**

Countries that have displayed inorganic growth of modern retail through large-scale corporatisation tend to be economies that have developed rapidly in the last 20-25 years. Among these are the East Asian economies and

I believe the Indian retail sector will evolve along a path that may be a hybrid, and in fact, may be closer to the European and American model, with a significant amount of entrepreneurial competition dominating the landscape.

the former communist Eastern European countries. Three critical factors that have enabled the disproportionate and rapid growth of corporate retail in these countries are: financial muscle, a bank of real estate and strong political linkages. In other countries the high share of modern retail has grown over many more decades.

In other countries such as those in western Europe and North America, retail consolidation has happened over many more decades, boosted occasionally by phases of economic boom (such as the 1920s, the 1950s and 1960s, and then the 1980s).

Many observers have imagined that India's retail growth would follow the East Asian and Eastern European countries' pattern, and have projected that India will reach a state of significant consolidation through corporate retail businesses by 2015.

If that were to happen it would be a rather sad "monoculturation" of the business. Fortunately, I believe, that it is not likely to happen easily.

Firstly, the modernisation of retail trade has typically moved in step with broader economic and infrastructural development. If we use per capita retail sales as a surrogate measure for the overall economic development of a country in conventional terms, the share of modern retail is closely correlated with that (see the accompanying table). Viewed through that lens, the Indian retail sector is still very far down on the list, and is likely to remain fairly fragmented for some time to come.

Secondly, India has a strong entrepreneurial and organic retail

ecosystem (not just retailers, but also suppliers and support organisations). Given the diversity of the market, and the sustained fragmentation of consumer needs, I believe the growth of India's retail sector will not be driven by large companies alone, although they are helping to accelerate the process of sophistication – indigenous, non-corporate retailers and their suppliers have a strong role to play in the ongoing development.

I believe the Indian retail sector will evolve along a path that may be a hybrid, and in fact, may be closer to the European and American model, with a significant amount of entrepreneurial competition dominating the landscape.

Therefore, it is important for the executives in corporate retail organisations to think innovatively, as an entrepreneur would – think truly like a "dukaandaar" (shopkeeper).

Country	Est. Share of Organised Retail (%)	Est. Per Capita Retail Sales (US \$)
USA	85	9,973
Japan	66	9,249
United Kingdom	80	7,851
France	80	7,124
Germany	80	5,109
South Korea	15	4,144
Czech Republic	30	3,301
Poland	20	3,150
Hungary	30	2,376
Russia	33	1,940
Brazil	36	1,520
Argentina	40	1,359
Malaysia	55	1,264
Thailand	40	1,043
Indonesia	30	665
China	20	599
Philippines	35	591
Pakistan	1	404
Vietnam	22	309
India	4	287

Source: Various, including ICRIER and Third Eyesight Analysis



Would a dukaandaar open a store in a place where he has no hopes ever of making money? Would he consistently follow this strategy for years? Would he believe that he is building brand equity and goodwill by doing so, that will sustain him in the future? The honest answer to all those questions would be an unqualified “no”.

Any long-term strategy can only be built on the premise that the business will be sustainable for that term. If the short-term cashflows are not available to keep the business alive, no amount of long-term thinking will help, as some retailers have recently acknowledged while shutting stores or entire businesses.

It is also important for the corporate *dukaandaars* to continue to evolve relationships with the fragmented supply base, and support the growth of indigenous national-scale suppliers.

### MODELS FOR INCLUSION

Inclusive growth has become a buzzword in recent years. However, I believe that India is one of the few major economies where it is more than just a buzzword.

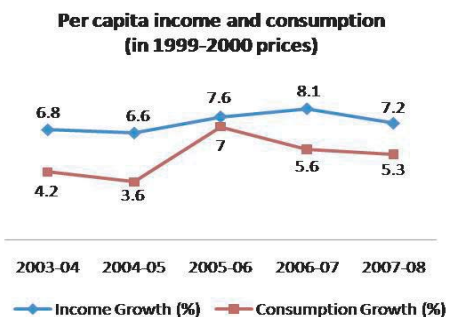
In 2006, at the National Retail Summit organised by the Confederation of Indian Industry, I expressed the concern that we were getting too preoccupied with the western model of urban economic development and consumption and ignoring the gap that was being created in India (the text based on that presentation is available on Third Eyesight’s website). To my surprise, I had no fewer than 60 conversations during the day about the subject, many of them with senior managers in large consumer goods and retail companies.

Clearly, the thought of sharing the growth and prosperity more widely

does strike a chord with many more Indian urbanites than one would realise. What’s more, quite a few companies are actually taking a direct approach into bridging the gap.

There is no one single model that is applicable to creating these bridges.

Some – large companies such as ITC and Mahindra or smaller ventures such as Drishtee – have created retail businesses that also act as local exchanges of services and goods in the



villages. Many of them include villagers as co-entrepreneurs through franchise structures, thus helping to generate and retain wealth within the locality.

Others – such as Fabindia among the visible, or Khamir and Dastkaar – are channels for rural artisans to participate in the economic growth as suppliers to the burgeoning urban demand.

Food retailers have started co-opting farmers into supplying to them directly, where possible. The attempt is to bypass middlemen who act as aggregators, thus making more margins available to both retailer and farmer.

Many farmers are indeed happy to put in some extra investment in minor equipment and some effort, to help grade, sort and clean the produce, so as to get a still better price.

Yet, certainly, more could be done. For instance, how about if the largest modern retailers in the country created a permanent display for regional crafts in all their stores, and took these along as they grow their chains in the coming years?

And how about retailers growing businesses through demand generated by economic growth in the much smaller towns? By encouraging regional suppliers and local buying (as opposed to the central purchase mindset), not only would retail chains be better merchandised for local needs, but also be plugged more into the local economy.

Let us not ignore the possibility of local retailers who are right now “flying under the radar” to become important factors in the growth of these smaller towns.

Demand generation in tTier III towns and semi-urban areas will accelerate as the logistical connectivity improves and shipping costs decline through multi-modal transport. There is significant investment happening in both road and rail connectivity, and the newly well-connected dots on India’s map are visibly more prosperous than earlier.

As these developments continue, we

Reacting to the high real estate costs, brands have begun looking at the possibility of generating higher gross margins. In most cases, this has meant that selling prices are pushed up, rather than sourcing costs being reduced.

should fully expect strong retail chains to begin building up, first locally and then regionally.

When we speculate about who India’s Wal-Mart might be, we shouldn’t forget that the world’s largest company emerged from sleepy, semi-rural locations in the US, and similar developments might happen in India as well.

### FACING THE CHALLENGES

The Indian retail sector also has some distinct environmental challenges that are bigger than the specific economic blip it is facing right now.

For instance, to my mind retail is an integral part of urban infrastructure, but in most cities retail is a sideshow for urban planners. Either the space provided is too little, or laid out in such a manner that no sensible retailer can expect to have a sustainable and profitable store in that location. Or, if a large space is provided for the private development of shopping centres, the public transportation connections are next to nil, while the car-carrying capacity of the connecting roads is usually poor.

Some of the other challenges are related to the Indian government regulations controlling the sector. As an example, in the area of fresh produce, some states still have regulations that restrict the wholesale trading of the commodities to the mandis, or controlled market yards. This means that the consolidation and processing of farm produce is more difficult and expensive.

Real estate costs are an ongoing challenge for retailers, especially those that wish to develop mall-based businesses. Some mall owners have begun evolving from being “builders” to mall managers with a long-term view on creating a business of shopping centre management, and have begun linking their rentals to the revenues actually generated by their retail tenants. However, in several cases, the real estate costs are still in the double digits.

Reacting to the high real estate costs, brands have begun looking at the possibility of generating higher gross margins to compensate. In most cases, this has meant that selling prices are pushed up, rather than sourcing costs being reduced. While the consumer has been largely transparent to these increases in the last couple of years, I don’t believe this to be a sustainable margin strategy. The cracks are already showing, in the steadily increasing volumes sold under discounts, and the emergence of discount retailers who sell off-season and surplus branded merchandise. The message, clearly, is: the real, sustainable, price is at least 25-40% lower than the MRP. The market looks ripe for the emergence of every-day-low-price business models.

### IF I WERE TO LIST OUT MY TOP PRIORITIES FOR RETAILERS IN INDIA, THESE WOULD BE:

#### Realistic demand estimation

Many chains are grappling with too much square footage in a certain geography in the form of very large

# The outlook towards retailing needs to change beyond the few government luminaries who can be identified as the retail sector's friends. Whether it is provided "industry status" or not, the fact is that retailing is an industry in India, and needs to be treated with more respect.

stores or too many stores. While allowing for the fact that the market is significantly different from what it was 10-20 years ago, let us not expect entire populations to have increased their consumption multi-fold. Sales expectations need to be realistic.

## Store productivity

For an entrepreneurial business, each store needs to produce results. Sure, there will always be some superstar stores and other locations that are a drag on the bottom-line. The performance needs to be analysed on an ongoing basis, and fairly dispassionately. Store productivity is a function of merchandise availability, store operations, advertising to build customer traffic and a host of other factors. However, unless the store is a marquee location (which very few are), there is no excuse for sustained losses. Fortunately, Indian management teams are today less scared of damage to their reputations, and more business-like when it comes to taking hard decisions on resizing, relocating or simply shutting doors.

## Pace your growth

Think of a teenager who gets into a growth spurt, and suddenly adds length to his legs. The gait becomes ungainly and he doesn't really know what to do with the extra inches. Many Indian retailers have gone through a similar disproportionate growth spurt. While stores have grown, the sophistication of the business has not. Let's remember, the race for retail market leadership is a marathon, not a sprint. The appropriate rate of growth should be determined by

organisational capabilities, rather than what others are doing in the market.

## People

There is no shortage of people in India, as one of the leaders of the industry pointed out a few months ago. Let's stop creating an artificial scarcity. There are people around who have been in modern retail trade in India for decades and are committed to it – they have the experience. There are others who have only recently entered but need direction and training. The investment in these two sets of people will possibly provide longer lasting returns than artificially inflated compensations for round-robin resumes.

A major "macro" risk to my mind is that retail is seen through narrow lens both by itself as well by as the Government and its various arms.

In most cases, the Government's various departments continue to treat retail as an incidental trading activity, or as a milking cow through indirect and direct taxes. The outlook towards retailing needs to change beyond the few government luminaries who can be identified as the retail sector's friends. Whether it is provided "industry status" or not, the fact is that retailing is an industry in India, and needs to be treated with more respect. Even the local *kiranawala* adds significantly to the community; even the fragmented market association keeps a vital part of the local ecosystem alive and ticking.

The other side of the story, the retail sector's perspective of itself, also needs to change. Retailers need to look beyond promoting short term

consumption. As they grow larger, they are beginning to have a disproportionate impact on society, lifestyles, income distribution and the broader economic fabric of the country. In most developed markets retailers realise how much change they can drive, and many are using this power to benefit themselves and their societies at large. As Indian retailers grow in scale, I think it would be wise to build the "corporate social responsibility" gene into the DNA at this very early stage.

## LOOKING TO THE FUTURE

Given recent developments, some people may feel that the retail boom is over and it may already be too late to enter the Indian market. I beg to differ: I believe there is still a lot of steam, a lot of energy in the Indian market.

In fact, it would be most appropriate to quote Shah Rukh Khan from *Om Shanti Om*, "Picture abhi baaki hai, mere dost!" ("The movie isn't over yet, my friend!")

The road to modernising the retail sector in India is long, and we have only taken the first few steps yet. Economically difficult times are wonderful opportunities for shedding flab, challenging existing business models and assumptions, and also provide great frameworks for building efficient and lasting companies.

In closing, I would like to borrow a theme from the two great growth sectors in Indian retail: food, and fashion. Both thrive on change. Both thrive on freshness. And that could be the winning theme across the Indian retail sector.

Here's to a fresh start in 2009! ■