FDI IN INDIAN RETAIL - AND ITS IMPLICATIONS

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Abstract

The health of a nation is gauged not only by the quantum of FDI it attracts but also the trend it follows. In turn this is dependent on the economic policies formulated and practiced and the willingness of all concerned to engage with global economic practices. Since the early 1990's when the government embarked on a policy of liberalization it has been observed that FDI inflows showed a steady increase until the last couple of years when in fact there has been a de-growth particularly 2010 over 2009 by almost 30%. On the other hand China has attracted FDI more than 4 times the quantum of India during the same period.

Investors will look to invest in 'opportunities' as they see bearing the most attractive returns within a given frame work considering both the 'home' as well as 'host' country. Facts and figures very clearly indicate the positive impact even in India for certain sectors when FDI has been embraced. On the other hand, India most urgently requires gathering as much as investment as is possible to keep the momentum of growth going and one such opportunity is the organizing of our retail segment which would support development endeavor in a big way. The issue of embracing partial FDI in retail has seen some level of procrastination which requires more urgent and serious attention. Can India afford to lose this opportunity?

This paper attempts to study the implications for this investment as also providing some suggestions.

Keywords: *Foreign Direct Investment, Organized retail, Traditional retail, Economic policies, Employment, Infrastructure development.*

FDI -A GLOBAL SCENARIO

For the first ever time since this concept of 'FDI' came into existence this world saw the flow of money channelized in the direction it originally was intended to and that is towards economies which are in transition and development. The year 2010-2011 in which about US$ 1222 billion flowed has been eventful for the world in every sense in terms of development, both with the financial markets and the political scenario. The two most important factors for any country in its overall development. The data sourced from UNCTAD and encapsulated below (Fig 1) amply illustrates the current position.

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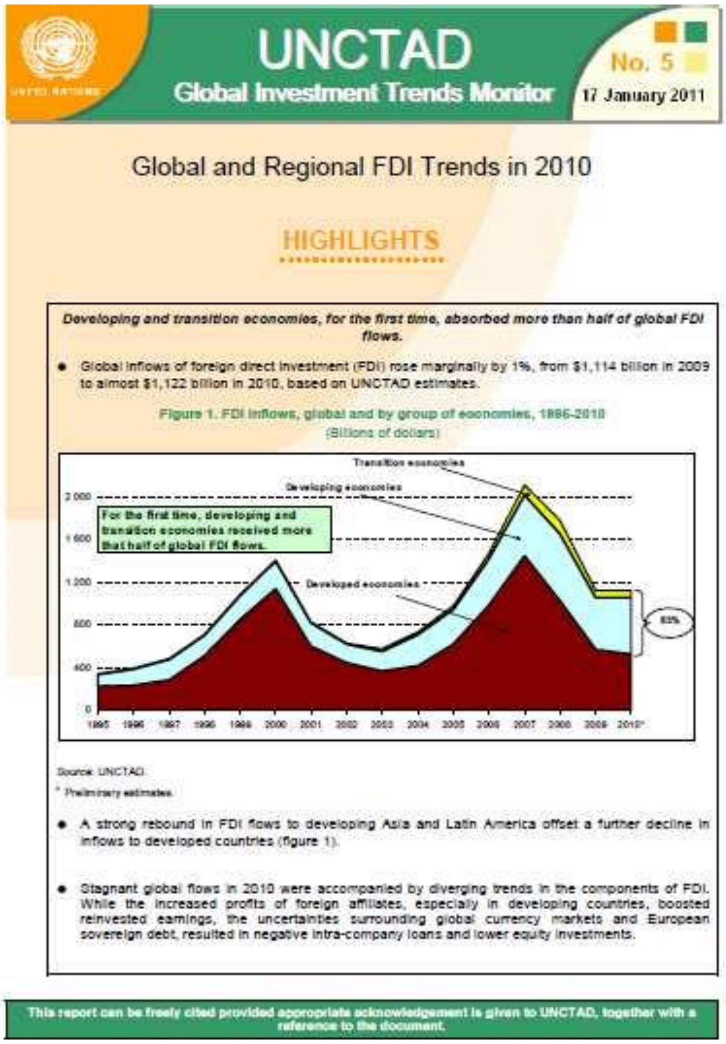
Fig 1. Global and Regional FDI Trends in 2010


UNCTAD

Global Investment Trends Monitor

No. 5

17 January 2011

Global and Regional FDI Trends in 2010

HIGHLIGHTS

Developing and transition economies, for the first time, absorbed more than half of global FDI flows.

- Global inflows of foreign direct investment (FDI) rose marginally by 1%, from $1,114 billion in 2009 to almost $1,122 billion in 2010, based on UNCTAD estimates.

Figure 1. FDI inflows, global and by group of economies, 1995-2010

(Billions of dollars)

Source: UNCTAD.

* Preliminary estimates.

- A strong rebound in FDI flows to developing Asia and Latin America offset a further decline in inflows to developed countries (figure 1).

- Stagnant global flows in 2010 were accompanied by diverging trends in the components of FDI. While the increased profits of foreign affiliates, especially in developing countries, boosted reinvested earnings, the uncertainties surrounding global currency markets and European sovereign debt, resulted in negative intra-company loans and lower equity investments.

This report can be freely cited provided appropriate acknowledgement is given to UNCTAD, together with a reference to the document.

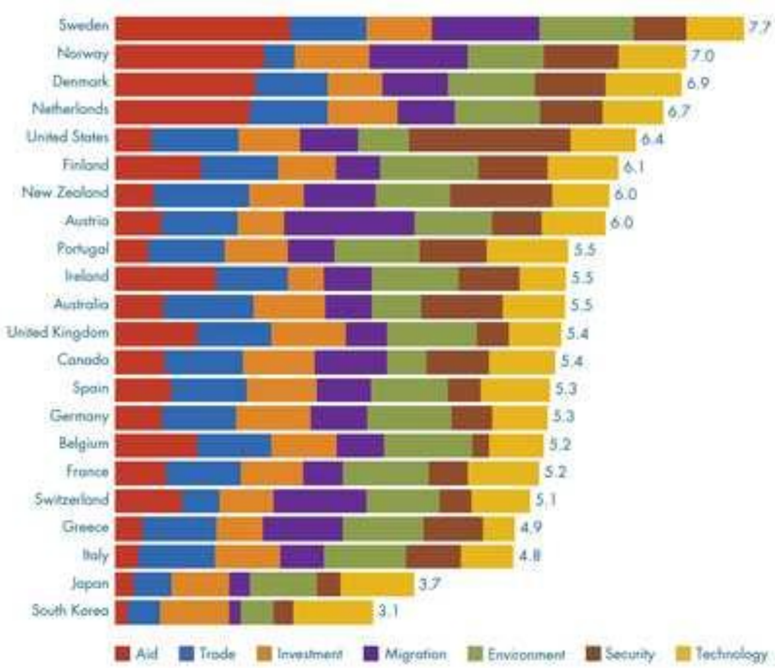
Source: UNCTAD

There are three important observations to be made with the overall global picture of FDI and they are in a way synergizing the very objective/s of this type of investment.

- The flow of FDI into developed and matured economies is declining due to home market saturation.
- Transition economies indicate a halt to their FDI slide with their propensity to adopt more liberal trade attitude and a win-win outcome.
- Developing economies have started receiving better inflows due to huge untapped markets and consumerism besides serving as a profit making opportunity for developed economies.

To add to above factors another aspect of great importance, namely ‘The Global Commitment Index `which reflects the mood of leading rich countries is encouraging. A graphical representation is depicted below (Fig 2) which should be read together with the UNCTAD report to understand the great opportunity this type of investment presents to the investor and investee.

Fig 2. Commitment to development Index 2011



Source: Center for Global Development

At 18 of these 22 countries were above average in their disposition. For the purpose of this paper we stay focused on the first three policy areas, namely, aid, trade and investment (FDI) though the other four policy areas Migration policies, Security policies, Environmental policies and Support for new technology cannot be ignored when actual investment is made. So each of this investing country gets scored on seven policy areas which are averaged for an overall score. While a score of 7 is considered good, the average was 5.

The Indian FDI Scenario

Foreign direct investment (FDI) capital flows into India have increased dramatically since 1991, when India opened it economy to FDI, and inflows have accelerated since 2000. FDI inflows to India reached $11.1 billion in calendar year 2006, almost double the 2005 figure, and continued to increase in the second half of the decade. The Indian government had announced a target of $25 billion in new FDI inflows for the 2007–08 fiscal year. Globally FDI has experienced a corresponding resurgence since 2004, recording year-on-year increase of 29 percent in 2005 and 27 percent in 2004, after declining for several years in the early 2000s. Consistent with the global pattern, FDI inflows into India declined between 2001 and 2003, before experiencing a resurgence that surpassed average global growth, with year-on-year increases of 45 and 72 percent, respectively, in fiscal years 2004–05 and 2005–06.

Preliminary data for inward FDI for the 2006–07 fiscal year show FDI inflows of $15.7 billion, representing an increase of 184 %, in rupee terms, over the preceding fiscal year. While there is a large percentage increase compared to the global average, the value of inward FDI flows to India relative to developing countries remains small. However, FDI inflows to India surpassed inflows to South Korea in 2006, making India the fourth largest destination for FDI in Asia, behind China, Hong Kong, and Singapore. The only bad period being 2010 when there was an actual dip in the inflow the quantum being US$ billion 24.2 ,a clear downward spiral over 2008 and 2009 and as a percentage a drop of more than 30 percent. However this could be attributed essentially to the upheaval in the global financial scenario besides the domestic political scenario.

India's investment policy does not permit FDI in the following sectors: housing &real estate except development of integrated townships and settlements, retail trading, lottery business, gambling and betting, agriculture (including plantations other than tea plantation). What must be noted here is that FDI up to 100% is permitted in some sectors under automatic route and this includes medical equipments and drugs and pharmaceuticals and pesticides except those requiring industrial licensing. More recently FDI has been permitted up to 51% in single brand retail. This sector is presently in focus and a subject of national debate with three key players involved in the process. The organized retail association, the traditional retail association and the government.

An Overview of India's Economic and Fiscal position:

Slides marked 'a' to 'm': Snapshot Slides. Source: www.dipp.gov.in

A) Economic Performance a picture of reasonable consistency:

Sustained economic growth

Average last 10 years 6.5%

2004-05 6.9%

Forecast up to 2006-07 >7.0%

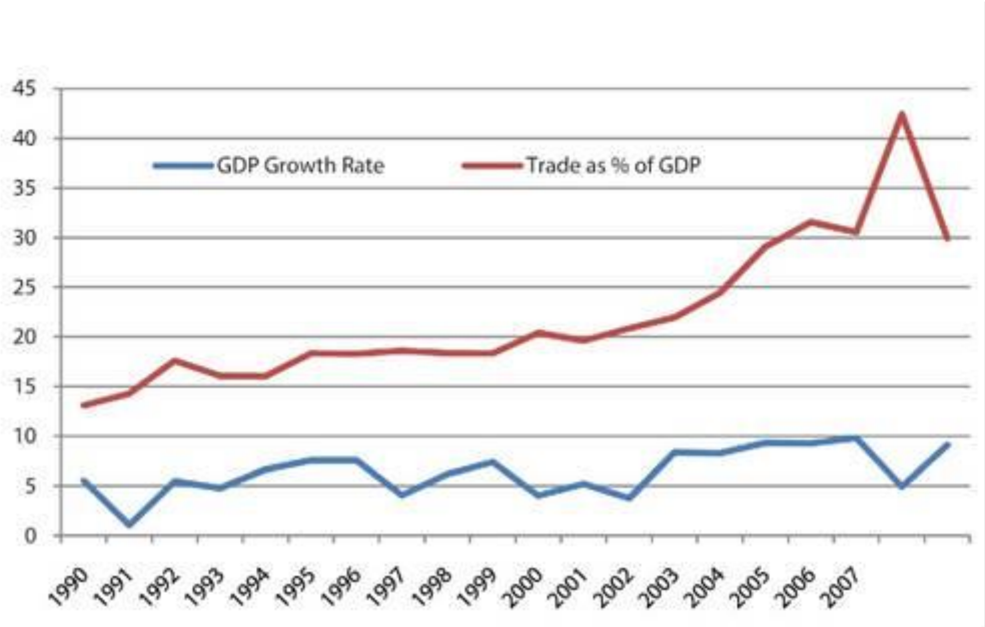
Forecast till 2050 – Goldman Sachs 5 % p.a.

2010 Real growth GDP of 10.1%

Services share in GDP over 50% (52.4% share in GDP in 2004-05)

At mid decade manufacturing sector growth stood at 8.8% in 2004-05 (17.4% share in GDP in 2004-05).

Fig 3. GDP growth rate (%) and trade as a % of GDP



SOURCE: Compiled from world development indicators database

Foreign Trade:

Merchandise exports grew by 25% in 2004-05, (US$80 billion) and the 2009-2010 figure stands at US$ 180 billion.

Imports grew by 36%, (US$106 billion) during the same period and for 2009-2010 stands at US$280. The figure below clearly depicts these facts.

Investment:

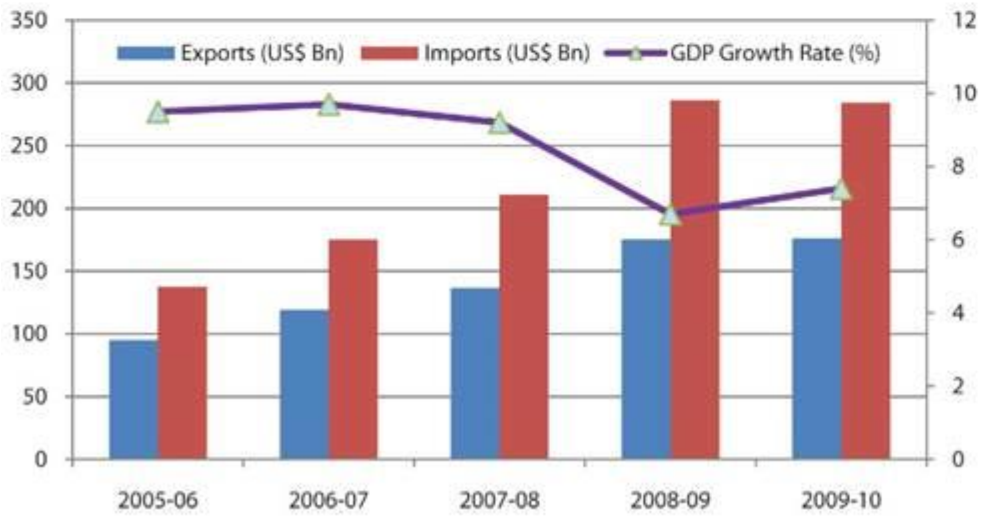
Foreign Investment – over US$14 billion in 2004-05 (FDI US$5.5 billion, FII US$8.9 billion) and for the year 2010 stood at US$ 24.4 billion.

Mature Capital Markets

NSE third largest, BSE fifth largest in terms of number of trades.

A well developed banking system.

Fig 4. India's growth, exports and imports (fy 2005-2006 till 2009-2010)



SOURCE: www.ibef.org

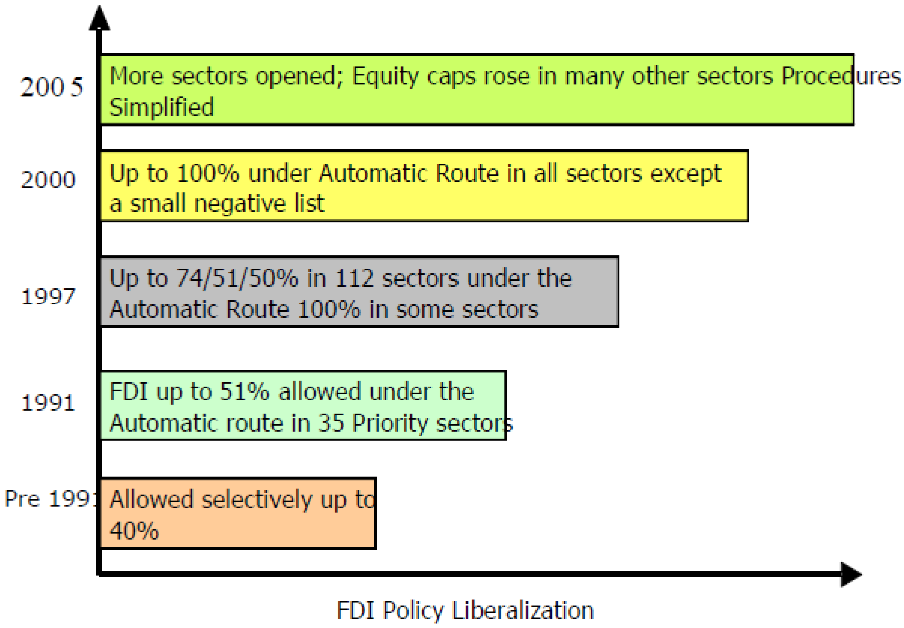
B) Rationalization of tax structure – both direct and indirect
Progressive reduction in peak rates
Peak Customs duty reduced to 15%
Corporate Tax reduced to 30%
Customs duties to be aligned with ASEAN levels
Value Added Tax introduced from 1st April 2005
Fiscal Responsibility & Budget Management Act, 2003
Revenue deficit to be brought to zero by 2008.

C) Industrial Licensing
Progressive movement towards de licensing and deregulation
Licensing limited to only 5 sectors (security, public health & safety considerations)
Foreign Investment
Progressive opening of economy to FDI
Portfolio investment regime liberalized
Liberal policy on technology collaboration
Trade Policy
Most items on Open General License, Quantitative Restrictions lifted
Foreign Trade Policy seeks to double India’s share in global merchandise trade in 5 years

D) Exchange Control
All investments are on repatriation basis
Original investment, profits and dividend can be freely repatriated
Foreign investor can acquire immovable property incidental to or required for their activity
Rupee made fully convertible on current account
Taxation
Companies incorporated in India treated as Indian companies for taxation Convention on Avoidance of Double Taxation with 65 countries
E&f

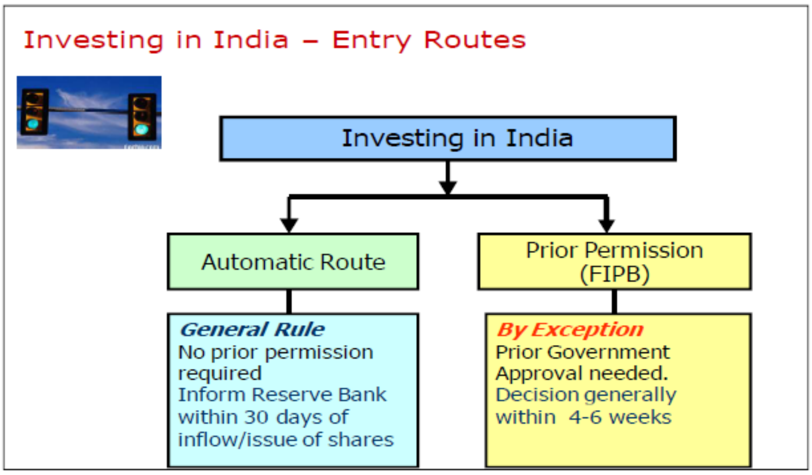
Evolution of FDI Policy

Fig 5. Evolution of FDI Policy



As can be observed from the above diagram (Fig 5) it must be said that India has progressively but cautiously liberalized its attitude towards FDI though we are tempted to ask whether the pace of this liberalization is adequate considering the domestic growth rate projected, the propensity of other developing economies to attract this investment and last but not the least the predisposition of developed economies to invest considering the fact that they see very little growth in their home market at present.

Fig 6. FDI Entry Routes



G) New sectors opened to FDI
Defense production, Insurance, print media -up to 26%
Development of integrated townships up to 100%
E-commerce, ISP without gateway, voice mail, electronic mail, tea plantation - 100% subject to 26% divestment in 5 years
FDI equity limits rose
Private sector banks rose from 49% to 74%
Drugs and pharmaceuticals from 74% to 100%

Advertising from 74% to 100%
Private sector refineries, Petroleum product marketing, exploration, petroleum product pipelines – 74% to 100%
Procedural simplification
Issue of shares against royalty payable allowed

H) FDI in domestic airlines increased from 40% to 49%. Automatic route allowed
FDI up to 100% allowed under the automatic route in development of townships, housing, built up infrastructure and construction development projects
Foreign investment limit in Telecom services increased to 74
FDI and portfolio investment up to 20% allowed in FM Broadcasting. Hitherto only Portfolio investment was allowed.
Transfer of shares allowed on automatic route in most cases
Fresh guidelines for investment with previous joint ventures
A WTO (TRIPs) IPR regime compliant in position since 2005 – Patents Act amended to provide for product patent in pharmaceutical and agro-chemicals also.

I) FDI up to 100% allowed under the 'Automatic Route' in all activities except for
Sectors attracting compulsory licensing
Transfer of shares to non-residents (foreign investors)
In Financial Services, or
Where the SEBI Takeovers Regulation is attracted
Investor having existing venture in same field
Sector specific equity/route limit prescribed under sect oral policy
Investments made by foreign investors are given treatment similar to domestic investors

J) FDI equity limit-Automatic route
Insurance – 26%
Domestic airlines – 49%
Telecom services-Foreign equity 74%
Private sector banks-74%
Mining of diamonds and precious stones-74%
Exploration and mining of coal and lignite for captive consumption-74%

K) FDI requiring prior approval
Defense production – 26%
FM Broadcasting -foreign equity 20%
News and current affairs-26%
Broadcasting-cable, DTH, up-linking – foreign equity 49%
Trading-wholesale cash and carry, export trading, etc., 100%
Tea plantation – 100%
Development of airports-100%
Courier services-100%

L) Foreign technology agreements also allowed under Automatic route:
Lump-sum fees not exceeding US$2 Million
Royalty @ 5% on domestic sales and 8% on exports, net of taxes
Royalty up to 2% on exports and 1% also permitted for use of Trade Marks and Brand name, without any technology transfer
Wholly owned subsidiaries can also pay royalty to their parent company

Payment of royalty without any restriction on the duration allowed.

M) 2nd most attractive investment destination among the Transnational Corporations (TNCs) - UNCTAD’s World Investment Report, 2005
3rd most attractive investment destination – AT Kearney Business Confidence Index, 2004
Up from 6th most attractive destination in 2003 and 15th in 2002
2nd Most attractive destination for manufacturing
Among the top 3 investment ‘hot spots’ for the next 4 years
UNCTAD & Corporate Location – April 2004
Most preferred destination for services -AT Kearney’s 2005 Global Services Location Index (previously Offshore Location n Attractiveness Index)

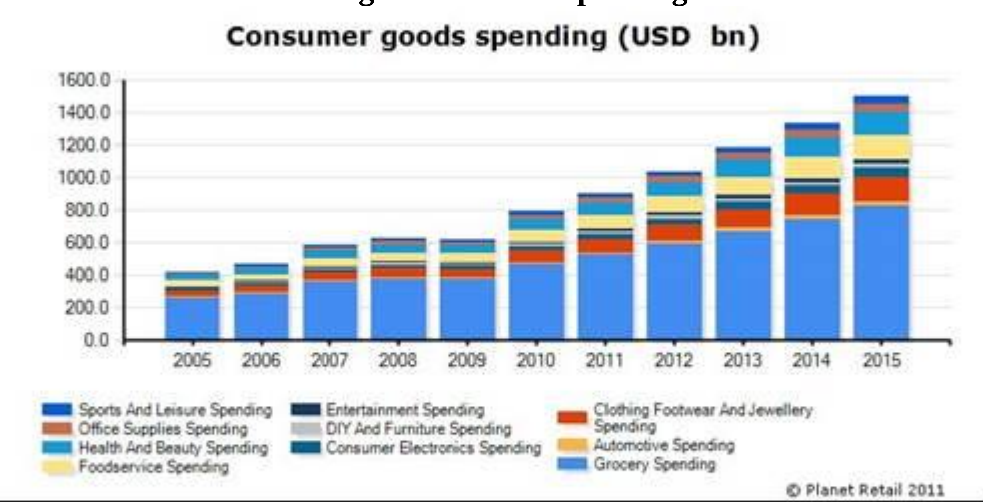
The above scenario is clearly indicative of the potentially optimistic outcome for the investee and investor.

Retail Scenario – India

Retail in India still does nnot enjoy the status of ‘Industry’ and is essen ntially dominated by traditional stores and the late est estimate is that this could be to the extent of 95%. There are a few large Indian corporate house es who have ventured into the domestic retail sspace with organized format and some of them are e well entrenched to capitalize this early entry a advantage. This being the broad domestic retail p picture the government is under constant pol litical pressure when discussing the issue of permittting FDI in the retail sector. It is estimated that thhere are more than 12 million traditional stores acro oss all categories of products which together contr ribute about 8% of the total national GDP besides be eing the second largest ‘employer’ only next to the agricultural sector.

The graphical representation (Figure 7) depicted below furnishes a visually picture for different categories together with the expected or forecasted spending well into the year 2015. Again this serves to confirm the potential the country offers. It must be mentioned here that it is interesting to observe the anticipated growth in dollar value terms.

Fig 7. Consumer spending



SOURCE: Planet Retail

The Indian retail sector is one of the least concentrated in the world. Together the top five domestic corporate retailers h have a combined market share that is a single d digit. The Indian retail scenario is one of contrasts, fragmentation and heterogeneous with the predominant role still played by the traditional set of family run stores and hawkers who through their trade associations are vigorously opposed to the entry of foreign retailers or their investment in this sector.

Despite this resistance there has been rapid growth with some domestic regional players setting up different retail formats leading to a future possibility of retail market getting concentrated and more organized.

Currently the Indian government has allowed 51% FDI in single brand retail and 100% in Cash & Carry that is B2B operation. It must be pointed out that a number of domestic organized players have also entered into collaborative arrangements with international retailers to take advantage of the huge retail market opportunity which the Indian market is projected to throw up. So to say just waiting on the sidelines.

The opportunities arising by virtue of getting organized by inviting international retailers and the consequent implications that this could have on the Indian economy is just one of the compelling factors for this paper.

As per the 'Mumbai Mirror' report dated 24th of February 2009 FDI inflow in 2008-2009 is likely to exceed US $25 billion despite the financial meltdown impacting the global economy. In fact it is expected that this quantum is likely to exceed US $25 billion that came in during 2007 – 2008. To quote N N Prasad Joint Secretary in the Ministry of Commerce, Government of India 'our FDI will be more than US $ 25 billion. It is a very good sign ...'. To make another interesting connection the program of 'Vision 2020' prepared by the Chemical and Fertilizers ministry to make India one of the top 5 global innovation hubs requires huge investment including substantial participation from the private sector under the public – private partnership model. This is what the Chemicals and Fertilizers minister, Government of India Ram Vilas Paswan had to say: 'the present state of infrastructure and R & D of the pharmaceutical industry in the country is rather weak. We need to bolster it immediately. Once this proposal comes through, India will become a global pharmaceutical hub. Five out of ten drugs being discovered in the world will be in India. We will also ensure patenting of our own drugs'. Hence there is a huge potential for FDI in the healthcare sector including its retail element and the policy body should not have any hesitation in permitting the same. When we consider the pharmacy retail there is a temptation to argue that it is a very specialized retail and directly impacts the welfare of mankind but on the other hand a closer look will reveal that all retail is concerned with the end consumer and does impact him one way or the other. Ultimately it is best quality at the most affordable price whether it is a prescription drug or a branded consumer product.

Even for a moment if one does consider organized retail just on healthcare retail front alone a myriad of associated activities are revealed. There is no going back on the fact that there is a dearth of educated and trained retailers who will by necessity have to be multi skilled. This in turn will call for competent human resource personal that are not only experts in their domain but in associated skills. A complete new breed of human resource professionals we require to generate.

Getting organized implies addressing the training issues of the existing unorganized employees as well as making provision for future requirements. Issues such as supply chain management very much a part of organized system will throw up huge opportunities both in terms of infrastructure and transportation development, not to underscore the role of information technology which is the very back bone of organized retail. The fact that we get access to modern and latest technology cannot be overlooked which once again would result spawning linked industrial sectors like barcode manufacture, RFID, electronic instruments and gadgets etc. One should not overlook the advantage of 'a learning experience on a golden plate' as these investors have been through the maze. That is a huge experience in different formats and markets is shared which would otherwise take decades and consume valuable time.

With good inflow of FDI in retail sector and the employment opportunities directly and indirectly interlinked it is very likely that the impact of FDI in retail will not be restricted only to the direct retail level but is more likely to be strongly felt by interlinked sectors. As mentioned in the earlier paragraph there will be a large requirement of Information technology professionals, experts in supply chain management and logistics system, transportation and communication besides the core implementation personal from the regulatory side. For example ‘Vision 2020’ for the pharmaceutical industry mentioned earlier on in this paper talks of Rs 5000-10000 crore being the investment amount and restricts itself with only’ drug development’ and mentions about 5 lakh jobs being created in 4 years time. India ranks the lowest in terms of per capita total health expenditure as well as per capita government health expenditure. We have a very long distance to go which in itself is an opportunity and will have economic ramifications if this issue is not addressed with urgency (reference to Working paper number 198 ‘ Impact Of Preventive Healthcare on the Indian Industry and Economy’- Alka Chadha et al). Take the health insurance industry it reveals that there are 800,000,000 individuals not covered by any insurance scheme. Some well know management authors and gurus have referred to this segment as ‘the bottom of the pyramid’ or simply BOP. If we have a healthcare system which is possible only if the retail is organized where the pharmacy forms part of the system a substantial number of these can be brought into the insurance umbrella with suitable models. A huge opportunity for employment generation due to infusion of funds into retail. In fact employment generation could be exponential as it will not be restricted only to the retail alone.

In a very recent article in ‘Hindustan Times’ dated 27th of December 2011 by Pankaj Mullick under the title ‘Ready, get set and give retail a go’ the potential of this sector if it receives FDI and the treasure trove it is, is revealed. He sums up with the following figures:

- Around $8 billion to $10 billion of fresh investments could come into the country in the next 5 to 10 years
- About 35 million people are hired by the Indian retail industry. Allowance of FDI could add at least another 10 million jobs in the next 5 to 7 years
- Employees at the managerial level in the retail sector can expect their salaries to rise 25% to 40%

Clearly the sectors which have been allowed FDI in the process of liberalization have done well. There is no indication to the contrary in any case. The probable hurdle here would be the future and role of existing retail workers in general. For example there is scope for attracting FDI in the healthcare retail segment alone in excess of US $2 billion taking care of its deployment over a period of time and canalizing the same into specific activities associated with retail (funding JV’s with traditional stores, funding training of employees of unorganized segment, funding formal and informal education centers). A time window of 2 to 3 years should be observed to usher in this change. This time frame is essential taking into consideration the social fabric of India. Extending this logically to the balance of retail market would indicate huge opportunities both in terms of lifting the economy and generating employment exponentially.

The government should step forward and take active part in creating awareness for organizing retail at the bottom of the pyramid thus gradually improving the standard of living, leading to encouraging demand and thereby fueling supply.

The time to act is now with India exhibiting a very high global services location index which could enable us to get substantial FDI, useful in upgrading our current living standards while generating employment opportunities exponentially.

Implications for India

As would any investor expect it is only fair that he would take for granted a decent rate of return on investments made with a reasonable assurance of safety coupled with the fact that this return would be for a period which would substantiate the efforts. Embracing this investment would entail embracing the system in totality save the peculiarities related to and impacting the host culture and in turn the return on investments. This implies technology, infrastructure, manpower, and other related or interlinked aspects.

It is widely believed in the retail sector that for every one person employed directly in retail there are nine others who are indirectly employed like supply chain, cold storage warehouse, transportation, back office support and other activities which actually aid in selling the product to the end consumer. This actually sums up the huge employment potential in this sector though it is beyond this paper to arrive at a specific figure in these related employment opportunities. All these activities would require huge investments which could be attracted as FDI.

In the case of India the problem is neither its lack of attractiveness as a destination for FDI nor the real need for the same. Both these aspects are apparent. But what really are the crunch issues then?

The primary issue is with the introduction of FDI in retail the investor will demand a level of organization of the retail leading to disturbing the existing traditional retail employees and due to the system of operations demanding better productivity which means better or improved margins for the retailer thereby cutting away margin eating activities of the existing system. This implies direct sourcing where the so called middle men (estimated to cost 10 to 15 %) of the total cost will be saved. This can translate into better prices for the consumer. A direct but distinct advantage of the organized chain concept.

Hence being a serious socio-economic issue these implications will need to be addressed if we intend going ahead and taking the reforms in our stride.

Issue 1: Retail sector being the second largest employer in India, close to 35 million people will be impacted directly if we ‘do away’ with traditional stores. So how do we gainfully engage them and in the process assure them their livelihood?

Issue 2: Will the government be truly supportive of other developmental issues which go to support issue 1?

Issue 3: The impact the above mentioned decisions 1 &2 will have on different stake holders not excluding different political parties.

It must be realized that international retail corporate entering India will have to work in tandem with governmental authorities and other associations for a predetermined timeframe in rehabilitating those individual businesses which are likely to be impacted within a given physical area depending on the location in the host country of the International retailer.

A super store is typically ‘a put together’ of a number of different stores offering different categories of consumer products under one large format. Whatever the extent of automation there will be a dire requirement of skilled personal and this human resource could be drawn from these existing traditional stores. This implies that such personal while having adequate experience may not have the required professional skills. Here comes the involvement of international and other governmental agencies to fully take part in ‘retraining’ such individuals. One method is to (as part of the permission to permit FDI) set aside a budget for this purpose which could be used in the upgrading of such individuals and the other could be supporting organizations which do so. Modern retailing also requires learning skills not directly involved with retailing, like warehousing, cold storage operations, bulk breaking and logistics. Investments are required here for training and upgrading which could be carried out in a continuous manner. By adopting this strategy a sizeable number of existing traditional stores would get adsorbed and later absorbed into the modern system where their past ‘local neighborhood’ experiences can be exploited by international retailers. For instance, local choice of brands, sentiments, culture etc…which have often been a huge deterrent to international retailers success in different countries? Examples of failures, Carrefour in South Korea and Wal-mart in Germany. The abundance of traditional store retail employees could very well be a boon to these international operators. This issue requires addressing the interests of different stakeholders involved in the process and work out a suitable and detailed plan. It is an issue of building a ‘win-win’ situation. For one, the existing employees of the traditional retail outlets could look at opportunities of getting employed formally and acquiring new skills.

On the second issue it is a question of how swiftly the government can and is willing to act. This could be in terms of further freeing up FDI norms in infrastructure development and modernization efforts, technology implementation, swift and committed clearances where required and perhaps looking at special terms for a fixed time period to motivate the investor. The other important issue but hidden from sight is the aversion of the ‘next’ generation in line to take over and run family owned stores. This is becoming increasingly obvious with rapid growth in technology and the younger generation not following the footsteps of the earlier members of the family. There is an increasing trend for them to educate themselves formally and get better recognized rather than just being ‘shopkeepers’. This is in fact a huge social pressure not obviously seen but felt. With more than 60% of its population in the ‘young age group’ segment it is imperative for the government to address this aspect with the next 5 years in mind. Also it should be noted that the government is indeed having to put up with ‘revenue leakage’ of substantial proportion as a bulk of such traditional stores do not generate any income for the government on one hand but avail all social services and other benefits expected by any citizen. Hence by formalizing retail such aspects would also get addressed.

This two pronged approach would not only protect the ‘interests’ of the impacted population but also speed up the development of the nation in many ways. Scientists have long ago formulated laws in Physics (Newton’s first law of motion) as well as human resource experts have supporting studies to show and demonstrate the ‘reluctance to change’. We have time and again been hearing that ‘only change is constant’. The need of the hour is to usher in the introduction of FDI in a phased manner taking into concern the issues of direct stake holders in this case the existing traditional retailers without political parties practicing ‘vote bank ‘ politics. The nation’s development cannot and should not be held back but in conclusion take care of the ‘consumers’ offering them the best of choice, price and service which would only be possible with inclusive organization.

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