# R&C Trendwatch

*November 2014*

# India: Positive signs for consumer goods, status quo for retail


## *Executive summary*

- *The outlook for the retail and consumer sector under the newly installed central government is positive, with some caveats.*
- *Consumer goods firms producing in India will benefit from government support for manufacturing, and the retail and consumer sector will benefit from a renewed commitment to improving infrastructure, increasing wealth across the population, and reforming inefficient tax and labor regulations.*
- *State-level politics remains a key determinant of reform, however, and firms should tailor their investment plans accordingly.*


## Introduction

For the retail and consumer sector, the elusive promise of India lies in the potential to penetrate its large domestic market, take advantage of opportunities to boost productivity from a low base, and attract its youthful and increasingly wealthy population both as employees and consumers. But despite its massive internal market and potential as a hub for low-cost manufacturing, engagement with India can be very challenging, especially for foreign firms—the country is ranked 134th of 189 on the World Bank's Ease of Doing Business Index.

Retail and consumer firms nevertheless remain optimistic. The relatively pro-business Bharatiya Janata Party (BJP) won this spring's general election, securing the first outright lower-house parliamentary majority in 30 years. Since taking office, it has bolstered consumer confidence and raised expectations of higher economic growth. Furthermore, the BJP's parliamentary strength virtually assures that it will serve out its five-year term and positions it to deliver on promises to further liberalize the economy, modernize and expand infrastructure, and support manufacturing, which should lead to job creation. Such moves would not only increase India's pace of economic growth well above 5%, but also lower regulatory burdens as well as compliance and logistics costs for retail and consumer firms. The overall outlook for the sector is therefore positive, with a few caveats.


*This publication is produced in collaboration with* ***Eurasia Group (www.eurasiagroup.net)****. Eurasia Group is a leading political risk research and consulting company.*

## Investment climate improving, particularly for consumer goods firms

Conditions will not improve overnight, but Prime Minister Narendra Modi has already taken a number of practical steps to implement his campaign promises to reduce restrictions to investment and boost the economy. He is initially concentrating this year on administrative measures that do not require parliamentary approval. These easy changes at the national level include loosening FDI restrictions in most sectors, introducing less punitive tax collection policies, and accelerating minority stake sales in state-controlled firms.

As part of his broad effort to make government more efficient, Modi is pressing the central government to more swiftly clear permits, relax some environmental regulations, and streamline new project approvals with an online application and tracking system. If a project has yet to begin work because of state-level clearance problems or other issues, New Delhi is now committed to working with private companies to help get their ventures back on track. These developments should enhance the overall business environment, as well as specific areas that affect the retail and consumer sector, including manufacturing and logistics.

Modi used his Independence Day speech in August to invite companies to produce in India. Authorities are seeking to encourage domestic manufacturing through generous tax incentives, improved infrastructure, eased regulatory constraints, and moderately protectionist policies aimed mainly at discouraging electronics imports. These developments should significantly benefit producers of fast-moving consumer goods, processed food, white goods, electronics, and apparel that are seeking to ramp up manufacturing within India.

## Foreign retailers will still face restrictions

That said, Modi's liberal inclinations are unlikely to extend to foreign multi-brand and online retailers facing restrictive investment rules. While the previous government allowed 51% foreign ownership in multi-brand stores, it made investment approval contingent on strict domestic sourcing requirements and separate state-level approval. Similarly, foreign e-commerce firms will probably remain confined to the marketplace model as prohibitions on selling directly to consumers are set to remain in place. These rules limit e-commerce firms such as Amazon to connecting consumers to third-party sellers and, in some cases, shipping the orders.

Small traders and shopkeepers that feel threatened by foreign players are a key BJP constituency that the government, with an eye toward upcoming state elections, is unwilling to risk alienating. So far, no BJP-ruled state has given permission for FDI in multi-brand retail, and this has been rolled back in states where the BJP has replaced incumbent Congress party administrations.

The central government's liberalizing push is also unlikely to help ease the expansion of organized retailers, which are struggling to compete with small, family-run kirana stores that continue to dominate as much as 90% of the $520 billion retail market. To open new stores, retailers must secure as many as 51 different local-, state-, and national-level permits. Under India's federal system, state governments are the main determinants of the operating environment for retailers, and this is unlikely to change. States that are welcoming to FDI in multi-brand retail include Congress party-ruled Maharashtra, Karnataka, and Haryana, but the central government's domestic sourcing requirements have kept all foreign multi-brand retailers other than Tesco from announcing plans to open stores.

## Receptivity to foreign multi-brand retailers by state

| | State/Union Territory | Population (millions, 2011 Census) | Per Capita GDP FY2013–14 (current prices, Rupees) | Per Capita GDP FY2013–14 (current prices, Dollars) | Openness to Retail FDI |
|---|---|---|---|---|---|
| 1 | Uttar Pradesh | 200 | 37579 | $626.32 | Hostile |
| 2 | Maharashtra | 112 | 107670 | $1,794.50 | Welcoming |
| 3 | Bihar | 104 | 33459 | $557.65 | Hostile |
| 4 | West Bengal | 91 | 70615 | $1,176.92 | Hostile |
| 5 | Andhra Pradesh | 85 | 89214 | $1,486.90 | Welcoming |
| 6 | Madhya Pradesh | 73 | 54030 | $900.50 | Opposed |
| 7 | Tamil Nadu | 72 | 112331 | $1,872.18 | Hostile |
| 8 | Rajasthan | 69 | 65098 | $1,084.97 | Opposed |
| 9 | Karnataka | 61 | 86788 | $1,446.47 | Welcoming |
| 10 | Gujarat | 60 | 96976 | $1,616.27 | Opposed |
| 11 | Odisha | 42 | 54241 | $904.02 | Opposed |
| 12 | Kerala | 33 | 88527 | $1,475.45 | Hostile |
| 13 | Jharkhand | 33 | 50125 | $835.42 | Opposed |
| 14 | Assam | 31 | 46354 | $772.57 | Welcoming |
| 15 | Punjab | 28 | 94532 | $1,575.53 | Supportive |
| 16 | Chattisgarh | 26 | 56990 | $949.83 | Opposed |
| 17 | Haryana | 25 | 135007 | $2,250.12 | Welcoming |
| 18 | Jammu & Kashmir | 13 | 58593 | $976.55 | Welcoming |
| 19 | Uttarakhand | 10 | 112428 | $1,873.80 | Welcoming |
| 20 | Himachal Pradesh | 7 | 92300 | $1,538.33 | Welcoming |
| 21 | Tripura | 4 | 60963 | $1,016.05 | Hostile |

| | | | | | |
|---|---|---|---|---|---|
| 22 | Meghalaya | 3 | 67515 | $1,125.25 | Supportive |
| 23 | Manipur | 3 | 36474 | $607.90 | Welcoming |
| 24 | Nagaland | 2 | 65908 | $1,098.47 | Unclear |
| 25 | Goa | 1 | 161822 | $2,697.03 | Opposed |
| 26 | Arunachal Pradesh | 1 | 84484 | $1,408.07 | Unclear |
| 27 | Mizoram | 1 | 60836 | $1,013.93 | Opposed |
| 28 | Sikkim | 0.6 | 142625 | $2,377.08 | Hostile |
| 29 | Delhi | 17 | 219979 | $3,666.32 | Opposed |
| 30 | Puducherry | 1 | 152090 | $2,534.83 | Unclear |
| 31 | Chandigarh | 1 | 152344 | $2,539.07 | Supportive |
| 32 | Andaman & Nicobar Islands | 0.4 | 91899 | $1,531.65 | Unclear |
| 33 | Dadra & Nagar Haveli | 0.3 | | | Welcoming |
| 34 | Daman & Diu | 0.2 | | | Welcoming |
| 35 | Lakshadweep | 0.01 | | | Unclear |

**Key**

| | |
|---|---|
| Welcoming | Formally allow MBR FDI |
| Supportive | Do not formally allow MBR FDI but have supported the idea |
| Opposed | Do not allow MBR FDI |
| Hostile | Actively oppose MBR FDI |
| Unclear | Unclear |

At 60 INR: 1 USD

## Tax reform and better infrastructure will (eventually) increase supply chain efficiencies

One of the most significant economic reforms that would speed the growth of the retail and consumer sector is the goods and services tax (GST), designed to subsume a host of disparate indirect central and state government taxes into a single consumption tax on goods and services. In its pure form, the reform would make India more of an internal common market, greatly reducing compliance costs and delays in transporting goods across state lines. But while state officials intent on preserving their independent revenue-raising authority will almost certainly dilute its final form with exemptions and greater leeway for states to set their own GST tax rates, thereby delaying implementation until 2016 at the earliest, the move will still be very positive for the retail and consumer sector.

Recognizing that poor infrastructure is one of the main constraints hindering more efficient manufacturing, the government is likewise committed to expanding and improving roads, railway freight lines, bullet trains, cold-storage facilities, and food processing plants. Government estimates suggest that India has half of the cold storage capacity it needs. New Delhi, as a result, is reviewing its public-private partnership models to attract new investment and increasing public financing for infrastructure. Retailers and consumer goods firms could curry favor with authorities by investing in this effort, which would also enhance supply chain efficiencies over the coming years.

Infrastructure to support e-commerce is also on a positive, albeit slow, trajectory. The telecom and IT minister has publicly noted that a plan to implement by 2016 the previous government's $4 billion project to connect 250,000 villages with broadband should dramatically expand the e-commerce market. Continued reliance on a squabbling and inefficient collection of state-controlled firms to execute the venture will likely see it completed behind schedule despite the renewed push from the top; however, once completed, it should substantially increase rural connectivity.

## Modi's liberalization push does not extend to trade policy

Trade is a potential weak spot in the outlook for the Indian retail and consumer sector: The BJP is broadly skeptical of international trade agreements that could constrict its ability to support domestic manufacturing, encourage exports, and discourage imports. In July, New Delhi effectively vetoed the WTO's Trade Facilitation Agreement in order to preserve its massive food subsidy program and solidify the BJP's popularity with India's rural and agricultural majority.

The government's unwillingness to sacrifice protections for domestic industries also dims the prospects for long-pending agreements with the US and the EU. Indeed, the new leadership has already pledged to review existing trade pacts, arguing that they have created an inverted duty structure that benefits foreign producers. Given that the EU is demanding concessions in sectors from alcohol to automobiles that India has refused to grant in past free trade accords with Japan and Korea, the proposed free trade agreement with Europe is unlikely to move forward.

India, at the same time, is unlikely to finalize a bilateral investment treaty (BIT) with the US. New Delhi has yet to complete its review of its model BIT text, initiated in 2012 as growing numbers of multinational corporations used BIT provisions to file international arbitrations. Whereas the US strengthened investor protections in its latest model BIT, India's new model will probably move in the opposite direction, particularly in terms of limiting recourse to international arbitrations. This stance on free trade could reduce the potential for India to become a hub or headquarters for some retail and consumer firms' global business, given that they would face a restrictive export-import regime compared to India's regional peers.

## State politics still a key factor

Retailers and consumer goods producers should monitor state-level politics because there are regulatory areas that the government is reluctant to take control of, for fear of denting its popularity. The states enjoy wide regulatory leeway over the sale of most goods, for example. In recent years, many states have banned the use of plastic bags, while the southern tourist hub of Kerala took steps this August toward joining four other states in banning the sale of alcohol. In mid-August, the state of Punjab issued a ban on the sale of junk food in schools, as well as a ban on children bringing junk food to school.

The states are likewise in charge of enacting controversial changes to restrictive labor laws. These include requirements that firms with more than 100 employees obtain government permission to lay off workers. Because retail and consumer firms are big employers, they will want to base operations in the states that have implemented the reforms. The BJP-ruled states of Rajasthan and Madhya Pradesh have already moved to relax restrictive labor laws.

## Faster growth is set to raise incomes and boost consumption

More rapid economic growth in India is increasing middle-class consumption, and Modi's victory has raised consumer confidence. Nielson's second-quarter Global Consumer Confidence Trend Tracker in July ranked Indian consumers the most confident in the world. The country's youthful demographics—the median age is 27—steady urbanization, and rising per-capita income are likely to drive growth in aspirational consumption of fast-moving and nondurable goods for decades to come. Roughly one million people are set to join the workforce each month through 2020, and while about 70% of the population still lives in rural and semi-urban areas, the UN estimates that the urban population is set to expand by 404 million by 2050. Moreover, modern retail penetration is currently low at about 5% and is expected to grow at a compound annual growth rate of 15%–20% by 2020. This will create significant opportunities for retailers and consumer goods manufacturers in a wide range of segments including luxury goods; convenience foods; household, health, and beauty products; and apparel.

Policy changes are also likely to bolster the incomes of those at the bottom of the pyramid. Over the next several years, the government's massive new financial inclusion program should help stabilize the incomes of the poor by introducing direct deposits of government transfers to recipients' bank accounts linked to a nationwide biometric ID system. Demand for lower-priced consumer goods should therefore increase alongside this effort.

Despite these positive policy changes, however, authorities are unlikely to meaningfully bring down persistently-elevated rates of food price inflation that act as a major determinant of purchasing power and patterns. Attempts to restrict vegetable exports, encourage states to take action against hoarders, release some public grain stocks, and launch a small price stabilization fund have proved insufficient. For retailers and consumer goods firms seeking to understand the current and developing behavior of the Indian customer, this is a key variable to monitor.

## *Strategies and implications*

- *Consumer goods firms considering production in India should position themselves to take full advantage of Modi's support for manufacturing and new projects. Logistics firms should also foster good relations with the government to guarantee its support for new business and investments.*
- *State level politics should remain front of mind for all businesses in the retail and consumer sector. For multi-brand retailers, state politics ultimately governs the investment climate, but for all firms the regulatory environment is heavily governed by the state.*
- *Companies should regard India as a long-term play. Though progress can be frustrated by political deadlock and competing interests, India's long term outlook as a manufacturing hub and a highly profitable consumer market is very positive.*
- *That said, headquartering in India may prove difficult for those companies reliant on a liberal trade regime because of the government's protectionist leanings and because India's regional neighbors are likely to have better trade relations.*

# Editorial


***Eurasia Group***
New York headquarters
149 Fifth Avenue, 15th Floor
New York, NY 10010
+1 212 213 3112
***Eva Molyneux***
Senior Analyst, Retail & Consumer
molyneux@eurasiagroup.net

***Mike Brewster***
Global Retail & Consumer Marketing
michael.j.brewster@us.pwc.com

***Susan Eggleton***
Global Retail & Consumer Marketing
susan.eggleton@us.pwc.com

***Denis Smith***
Global Retail & Consumer Marketing
denis.s.smith@hk.pwc.com


# Resources


***John G. Maxwell***
Global Retail & Consumer Leader
john.g.maxwell@us.pwc.com


www.pwc.com/r&c