Business models for entry of FDI in Indian Retail Market and its impact

*Sita Mishra**

Abstract

Retailing occupies a pre-eminent position in the economies of all modern societies. The business of retail in India has seen significant changes in the last few years. We have seen the emergence of new formats, entry of big domestic players, the application of global concepts and constructs albeit with modifications to suit the Indian environment. One of foremost issue, which is hot up once again, is discussion on gateways of entry of foreign direct investment in retail and its impact. This debate invites mixed reactions-proponents articulate that it will enhance exports and create jobs while opponents argue that the advent of retail giants will pose enormous risks. The focus of this article is on identifying the business models for entry of foreign direct investment (FDI) and presents analysis of the role of FDI in Indian retail market.

Introduction

India is poised on its way to emerge as a first-world economy in the areas of information technology, biotechnology, pharmaceuticals, the automotive sector, and now the thrust is on the retail sector to facilitate the creation of a new surging modern India. With escalating consumerism, unprecedented awareness, and a youth-heavy customer base, India is the 'Most Promising Land' for the Global retailers. The Indian retail market is attracting a large number of international players in anticipation of explosive growth. As per the new study by the McKinsey Global Institute (Beinhocker, Eric D. et al 2007), an economics research arm of McKinsey's, India is becoming the world's 12th Trillion dollar economy, and further it predicts that India is well on its way to become the world's fifth-largest consumer market by 2025. Currently, India is ranked as the12th largest consumer market in the world. India has topped the AT Kearney's annual Global Retail Development Index (GRDI) for the third consecutive year, maintaining its position as the most attractive market for retail investment among the 30 emerging markets across the world (GRDI report, June 2007). According to the recent Federation of Indian Chambers of Commerce and Industry (FICCI report, 2007) report, the organized retail sector is likely to increase its share from the current 4% to over 20% by 2010. Organized retail sector is on high growth trajectory, and is expected to grow by around 27% per annum in the next 5-6 years (CRISIL report, 2007). According to FICCI retail report (2007) over $30 billion of investment is likely to be made in the next five to seven years in these new retail models, 92% of which is slated for urban areas. The world is now looking

** Dr. Sita Mishra*
Assistant Professor, Marketing
Institute of Management Technology, Ghaziabad
e-mail: smishra@imt.edu

at India as the nation of the future.

FDI is considered to be the lifeblood for economic development as far as the developing nations are concerned. FDI to developing countries in the 1990s was the leading source of external financing. FDI is playing an increasingly important role in the world economy, as the rate of globalization increases, and the economic linkage between countries strengthens. Foreign direct investment (FDI) is the vehicle by which firms achieve their strategic objectives. FDI is widely regarded as an amalgamation of capital, technology, marketing, and management (Cheng and Kwan, 2000). A company must possess some asset such as product and process technology or management and marketing skills that can be used beneficially in the foreign affiliate in order to invest in production in foreign markets. While economic growth and technology transfer to the host country are important consequences of FDI, development of technological infrastructure and human capital are critical prerequisites and so antecedents for FDI (Noorbakhsh and Paloni, 2001). Market size and growth, barriers to trade, wages, production, transportation and other costs, political stability, psychic distance and host government's trade and taxation regulations, performance requirements, cultural distance, GDP per capita and infrastructure are factors affecting FDI location (Dunning, 1993).

Government's favourable talk on Foreign Direct Investment (FDI) has ignited ambitions in many of the global players to be among the first movers in Indian retail market. With fast saturating Western markets, global players are gradually realizing the potential of the retail sectors and the Indian consumers as the unexplored gold mine. But the Government is reviewing the impact of foreign direct investment in the retail sector and is adopting a highly calibrated approach towards allowing FDI in the retail market. Foreign direct investors' advantage stems from their special experience and know-how in a particular industry outbidding other investors for the top productivity firms (Razin and Sadka, 2003). Foreign direct investment may promote economic development by helping to improve productivity growth and exports in the multinationals' host countries. But the exact nature of the relationship between foreign multinational corporations and their host economies seems to vary between industries and countries (Blomstrom,1996).

The issue of FDI has been debated time and again as the Indian Government has been under pressure to open up further. Regardless of the opposition presented by the Left parties, some developments have been made in this regard. The policy makers continue to explore areas where FDI can be invited without hurting the interest of local retail community.

Business Models for Entry

Despite FDI restrictions in retailing, it has not discouraged the entry of major international players in India as they expect the norms to be relaxed in future. Foreign direct investment contributes most to the development process when the affiliate is wholly owned and fully integrated into the global operations of the parent company (Nunez, 1990). Developing countries need to have reached a certain threshold of development before being able to capture the benefits associated with FDI (Saggi, 2000). Currently, in retail sector in India, FDI are allowed to make their entry through Strategic licensing agreement, Franchising, or Cash-and-carry business model.

Strategic licensing agreement

Strategic licensing agreement route involves the foreign company entering into a licensing agreement with a domestic retailer. SPAR, swiss retailer, has entered into a similar agreement with Radhakrishna Foodlands Pvt Limited. The arrangement between SPAR and RK Foodland leverages SPAR's experience of retailing in diverse communities and geographies, while RK Foodland brings to the venture its expertise and experience as managers of a comprehensive range of food services in India. Recently, Phillips-Van Heusen Corporation announced a new licensing agreement with Arvind Brands Ltd. to design and distribute apparel under its well-known IZOD sport-inspired lifestyle brand. This strategic licensing arrangement provides Arvind with the right to distribute apparel under this iconic American brand both at wholesale and through its own IZOD flagship stores in India. Murjani group has distribution and retail licensing agreements with some well-known luxury brands, including Tommy Hilfiger, Calvin Clein, Gucci, Jimmy Choo, Tumi and the French Connection.

Several other players are also planning to enter through licence agreement viz. French footwear company Homme Global with East Face Footwear Pvt. Ltd, Disney consumer products, a unit of Walt Disney Company India, with R J corp.

Cash-and-carry

FDI is also permitted in cash-and-carry outlets, where goods are sold only to those who intend using them for commercial purposes. FDI was allowed in 'cash and carry' trade way back in 1993. It did not attract much attention and remained in a limbo. Two of the largest groups which operate under this format are Germany's Metro AG, and South Africa's Shoprite. Metro AG of Germany was the first to start the cash-and carry format in India. Waiting in the wings and actively negotiating with several Indian companies as potential partners are Tesco of the U.K. and Carrefour of France. Wal-Mart has also plans to enter through the cash-and-carry format, with Bharti supplying Wal-Mart's stores in India. French retailer Carrefour is also planning to enter the country through the wholesale cash-and-carry route.

Franchising

Franchising is the most widely used entry route by international retailers. In the 1990's as the market opened, foreign franchises started coming in gradually, and faced many hiccups along the way especially KFC, Schweppes etc. Since then there has been progressive entry of international franchises, some have been successful and others not so fortunate. The well-known franchises relating to soft drinks, ice-cream parlours or restaurants include Pepsi, Coke, Baskin Robbins, Subway, McDonalds, TGIF, Geoffry's, Taco Bell, Pizza Hut, Dominos Pizza, O'Brian's Sandwich Bar, Ruby Tuesdays and Barista. Fast food retailers like Domino's have entered India through the master franchise route while Pizza Hut has entered India through a regional franchisee .Retail franchises include Marks & Spencer, Pepe Jeans and Adams. Courier companies like Air Action and DHL are there along with computer and software related franchises.

The Government has liberalised the rules and regulations in relation to the retail industry and a boom in this sector is on its way. The UK Home Retail Group's Argos retail is planning to enter India through a franchise arrangement with two leading store chains. Shopper's stop and Hypercity Mall to launch the Hypercity Argos retail concept. Several other British retailers including Mothercare, also in association with Shoppers Stop, have used the franchise model to enter India, while Tesco is in talks with the Tata Group for an alliance. The Tata Group has already partnered with Australian retail giant Woolworths for its foray into consumer durable retailing under the Croma brand. Woolworths provides sourcing services and technology inputs to the Croma chain, which is controlled by Infiniti Retail – a fully owned subsidiary of Tata Sons.

Based on entry through different business models, the appropriate market entry strategy can be formulated for penetrating in Indian market by these international retailers, which are now looking to India to achieve breakthrough growth. Large Indian retailers are announcing launching of separate companies to facilitate entries of global brands through franchise and license arrangements.

Developments in Policy on Foreign Direct Investment in Retail

In January 2006, the Union Cabinet approved a major rationalization of the policy on foreign direct investment (FDI) to further simplify the procedures for investing in India and to avoid multiple layers of approvals that were presently required in some activities. With a view to facilitating the easier inflow of FDI into India, it has been decided that instead of having to seek FIPB approval, FDI upto 100% would now be allowed under the automatic route for cash and carry wholesale trading and export trading. So far, FDI in wholesale cash and carry trading and FDI beyond 51% in export trading required prior government approval. The Cabinet has also approved to allow FDI up to 51% with prior Government approval for retail trade in 'Single Brand' products. This is aimed at attracting investment, technology and best global practices as also catering to the demand of such branded goods in India. This would imply that foreign companies would be allowed to sell goods sold internationally under a single brand, viz., Reebok, Nokia, Adidas. Retailing of goods of multiple brands, even if such products are produced by the same manufacturer, would not be allowed.

The government is looking at allowing up to

100 per cent foreign direct investment in at least five specialty retail areas, including electronics, sports goods, building equipment and stationery.

With a robust economy experiencing sustained growth, India is proving to be an irresistible temptation to companies looking to expand their scope of operations. The idea of permitting FDI in the retail sector has seen various ups and downs. In 1993, the then finance minister Dr Manmohan Singh had changed the law to permit FDI in retail trade. Dairy Farm, a multinational corporation entered India on that opening. But, the next finance minister, P Chidambaram, changed the law again in 1996 to ban FDI in retail trade, but there existed certain ways by which foreign retailers can operate in India through local franchises. Again, in 2005, the new United Progressive Alliance government is grappling with same question whether or not to permit FDI in retail trade. Thus, the issue of FDI has been debated time and again as the Indian Government has been under pressure to open up further. Pending the opening up of the organised retail sector to FDI, the Government has already done considerable spadework in this area and has taken some significant decisions aimed at preparing the industry for a quantum jump with the help of FDI. However, with the government showing proclivity in allowing FDI for high end and grocery retailing, the idea of permitting FDI in the Indian retail sector is slowly gaining momentum.

An analysis on the various aspects of allowing or not allowing FDI in the Indian retail sector is presented below.

Why we should permit FDI in Indian retailing?

The proponents favouring FDI in retail sector argue that it would lead to increased efficiencies in value-chain, employment creation and exports. FDI in retail sector has been a key driver of productivity growth in Brazil, Poland and Thailand. This has resulted in lower prices to the consumer, more consumption and higher profit for the producer. FDI in retail trade has forced the wholesalers and food processors to improve, raised exports, and triggered growth by outsourcing supplies domestically. The availability of standardised products has also boosted tourism in these countries.

Consequently, some of the specific reasons for supporting FDI in India are as follows:

Benefits to Indian partners

Under present norms, 100% FDI is allowed only in cash and carry and backend operations, the front-end is owned by Indian counterpart. This provides protection to Indian partners as foreign partners can only enter through joint venture with them. This will enable the Indian partners to learn from the foreign players and thus improve their efficiency and capability. Foreign investment may benefit host countries through transfers of technology, stimulation of technology diffusion from new competition, and provision by foreign firms of worker training and management skill development (Harrison, 1994). Another advantage would be by being closely associated with the local suppliers and consumers, these global players would be in a better position to develop and control the supply chain, including the quality input, the manufacturing process, the design, the standardization, the labelling, and so on, to suit the changing global requirements.

Welfare of consumers

FDI in retail would mean competition to big domestic players from big global players. This would keep the organized retail players, both domestic and global, on their toes and in all likelihood would result in a war of sorts that may ultimately lead to benefits for the customer. With entry of FDI in retail, it would help consumers to buy plethora of products of world standard. They are also expected to get true value of their money. Many factors would contribute to this consolidation: economies of scale, ability to buy in bulk, reduction in distribution costs, implementation of efficiency-enhancing innovations etc.

Gain for producers

India has a distinctive problem wherein a large number of intermediaries present in the supply chain. Consequently, the consumer ends up by paying higher prices while producers, specifically farmers, receive a meager amount of their share. As these global players would mostly buy directly from the producer, therefore it would reduce middlemen in supply chain and as a result higher profits for the producers. In retail, which is growing at a robust pace, benefits to growers and farmers through backward linkages are assured because large companies have the logistics capability to reach fresh produce to the consumer through cold chains (Srinivasan, 2007). There is evidence of more intensive coaching for suppliers in quality control, managerial efficiency, and marketing than any other means for firms in the local economy to gain these skills (Nunez, 1990).

Advantage for small retailers

It is possible for small retailers to purchase quality products at low prices from organized players and sell them in smaller towns and villages where the global players will not be able to penetrate.

Sourcing opportunity

In general, it has been noticed that the global retailers outsource everything from low-wage, quality-producing countries .When Global players will set up operations in India, they will develop a strong linkage with local players and suppliers which will induce them to buy large quantities from India for export purposes on a long term sustainable basis. Hence total value of export will rise in the country. Looking at scenario in China, it is observed that after FDI's entry, its exports have gone up and it has become the world's manufacturing hub. Alongside, it has created employment for millions of Chinese. This is what proponents of FDI in retail are arguing for India also. At present, Global retailers buy about $60 billion of goods each year from China whereas their sourcing is for less than $1 billion from India (Kanungo, 2006). Therefore, there is enormous scope for increasing sourcing opportunity.

Cost Economies

Much FDI activity is achieved by way of a joint venture between a foreign company and an indigenous company and this may bring advantages such as risk diversification, capital requirement reductions and lower start-up costs (Perlmutter and Heenan, 1986).

At present, there is tremendous amount of wastage and loss in unorganized sector specifically in agriculture products due to lack of proper storage, transportation and processing. According to McKinsey, India wastes nearly Rs.50,000 crore in the food chain itself. These global players can bring their better managerial practices and IT-friendly techniques to cut wastage and set up integrated supply chains to gradually replace the existing unorganise and fragmented retail market.

Effect on economy

FDI in retailing will enhance the country's exports and open job prospects for millions. Experience everywhere has shown that organised retailing tends to have a major controlling effect on inflation because large organised retailers are able to buy directly from producers at most competitive prices. FDI will improve competitiveness and, thus, create employment and increase the welfare of the host nation (Dunning, 1994). This is a result of inward investment increasing the number of entrants in the indigenous industry which forces all competitor firms in the industry to become more competitive by reducing costs and improving efficiency and quality.

While these mega-stores may boost exports and buy directly from farmers, invest in food processing and raise the standards of agricultural products, they would affect the livelihood of 15 million small retailers across the country.

Why we should forbid entry of FDI in Retail?

Although, supporters of FDI provide a number of reasons for permitting them, but opponents condemn their entry and present some strong arguments against opening up the Indian retail sector. Some of the specific reasons against permitting Foreign Direct Investment (FDI) in this sector are as follows:

Threat for small players

Retail market in India is dominated by small players. With the entry of FDI, the retail chain can expand only by displacing the unorganized sector which would debilitate the employment scenario of the country. Many of small players are bound to collapse, and add to the already large pool of unemployed. Further, with little formal education/training, these people may not land the jobs that the retail giants will create. Entry of FDI in retail poses a threat for millions of small local players/ mom and pop grocery shops, as these shops do not have wherewithal to compete with the onslaught of these global players.

Impact on Labour

Another concern being raised is the likely impact on wages and labour welfare. Although, with the entry of FDI the employment may increase but it may lead to rampant violations of workers' rights. Many retail chains, such as Wal-Mart, attract customers by extreme cost-cutting measures including labour costs. A US House of Representatives Committee's 2004 report concluded that Wal-Mart's success has put downward pressures on wages and benefits, workers' basic rights and threats to the standard of living in communities across the country. Such squeezing of wages and violation of worker rights cannot be ruled out in India.

Issue of Predatory Pricing

These global players have power to annihilate domestic players by charging low prices. They have ample funds to sustain prolonged losses over a relatively long period of time. Small players don't have resources to withstand the force of these mighty global players and thus have no option except to fold up their businesses. This is usually predatory strategy followed by giant players which is followed by increase in prices once the competition is over , thereby leading to exploitation of consumers.

Outsourcing Issue

Regarding outsourcing products, there is really no guarantee that these global players would buy from India. They may well source from equally low-wage countries such as Thailand, Bangladesh, Nepal or China. Similarly, there is no guarantee that they will invest in food processing or bring in modern inventory management techniques that would help farmers sell their produce directly to them and earn a better price (Kanungo, 2006).

Real Estate and infrastructure

Large retail chains are likely to establish their outlets in major cities and urban areas which would further shoot up cost of real estate because of increased pressure on land. It is really becoming difficult to find adequate space for such organized stores with requisite parking in metropolitan cities. Moreover, malls in these metro cities also create traffic bottlenecks.

Effect on Economy

Permitting FDI in retail would have cumbersome implications on Indian economy. Instead of flow of foreign capital in India, most global retailers who have set up base here, have borrowed locally to fund their operations as there are many financial institutions which lend them capital at competitive rates. The cost of capital incurred by an Indian retailer, especially the smaller players, is significantly higher than that of foreign players. Such a situation would lead to a huge price disparity between the foreign owned retail chains and local Indian retailers.

Conclusion

The debate on Foreign Direct Investments in retail is deadlocked between extreme perceptions. This is a debatable subject by the Government for years now and it just never seems to stop. The ruling Government has raised fresh concerns on how FDI in Retail and impact of giant global players on small retailers and Common Man. Although the government is debating the level of FDI in retail, a number of foreign players have announced their intention to enter India in a big way as India offers the greatest opportunity for retail business. But global players also keep it in their mind that Indian retail market also offers the most complex challenge for them. Global retailers who have succeeded abroad in multiple countries may face struggle in India. But the size of Indian opportunity is so much that global retailers are ready to take their chances. The success of these players in India will depend on the local partners, consultants and executive leadership.

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