Special Report

# Indian Retailing: Investing for Growth

### India Retail Ratings

| | Short-Term Rating | Long-Term Rating |
|---|---|---|
| Shopper's Stop Ltd | F1(ind) | - |
| Pantaloon Retail India Ltd | F1(ind) | - |

### Select International Retail Ratings

| | Region | Short-Term Rating | Long-Term Rating |
|---|---|---|---|
| Asda Group Ltd | GBR | F1+ | AA- |
| Boots Group Plc | GBR | F2 | A- |
| Carrefour | FRA | F1 | A+ |
| Costco Wholesale Corp. | USA | F1 | A+ |
| Gap, Inc. (The) | USA | - | BBB- |
| Home Depot Inc. (The) | USA | F1+ | AA |
| J Sainsbury Plc | GBR | F3 | BBB |
| Marks and Spencer Group PLC | GBR | F2 | BBB+ |
| Metro AG | DEU | F3 | BBB |
| Sears, Roebuck and Co. | USA | - | BB |


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### Related Research

Fitch Special Report: *Indian Retailing – Birth Pangs*, August 2003, *available on www.fitchindia.com.*

### Contents



## ■ Executive Summary

Growth in Indian retail has been driven by the country's economic fundamentals over the past few years, including an increase in the proportion of upper income households, rising consumption expenditure and greater use of credit cards. Consumers are showing a growing preference for organised retail, resulting in increased penetration, from around 1% of total retail consumption in 1999 to nearly 3% in 2004 (or some INR280billion), and Fitch Ratings believes that this could rise to about 8%-10% over the next five years.

Organised retail continues to be focused on food & groceries and apparel. Key players have continued to customise their formats to better service their target markets. For example, the hypermarket format has rapidly gained popularity and is likely to expand the fastest, albeit largely confined to India's bigger cities. Competition in the supermarkets segment is likely to intensify, squeezing margins. Gaining critical mass and promoting private labels will be critical to profitability. The department store format is likely to show strong growth, again largely restricted to the larger cities. Speciality retail is also evolving in categories such as durables and jewellery, but remains in its infancy.

Retailers are using a combination of better bargaining power with suppliers, investments in supply-chain infrastructure to improve inventory management and the promotion of private labels to enhance margins. Larger retailers like Shopper's Stop Ltd ("Shopper's Stop") and Pantaloon Retail India Limited ("PRL") have realised operational efficiencies, as reflected in their financial performance. The rapid development of malls in India over the past few years in the major cities is expected to continue in the medium term and benefit retailers by increasing the availability of retail-focused real estate.

The financial flexibility of larger retailers has improved significantly over the past two years with new financing sources becoming available. The industry is thus gaining acceptance within the investor community. However, the pace of expansion has resulted in negative free cash flows for most retailers as internal accruals have proved insufficient to meet expansion plans.

Sector growth prospects are likely to be limited by factors such as restrictions on FDI (foreign direct investment), the lack of a uniform tax structure, increasing pressure on infrastructure in key consumer markets and a shortage of quality real estate. However, the government has attempted to alleviate these issues, proposing various regulatory changes (e.g. VAT legislation and FDI specifically for construction), which should prove beneficial in the medium to long term.

**12 April 2005**

## Industry Overview and Key Drivers

Historically, the Indian retail sector has been dominated by small independent players such as the local *kirana* stores (traditional, small-format, neighbourhood grocery stores) and "mom and pop" outlets. During the 1990s, organised retail gained increased acceptance, which has since accelerated. For instance, in 2003 alone, an estimated 10m sqft was added to organised retailing in India, higher than the additional retail space added in aggregate in the preceding decade.

Over the past few years, the Indian retail sector has been characterised by:

- larger store formats;
- rapid expansion across formats by existing players; and
- more players with a variety of formats.

The key growth drivers for organised retail are:

- growth in *per capita* income and household consumption;
- changing demographics and improved standards of living;
- changing consumption patterns and accessibility to low-cost consumer credit;
- infrastructure improvements and increased availability of retail space; and
- access to capital markets and other sources of financing.

## Growth Backed by Fundamentals

The Indian retail industry has been driven by strong growth in the country's economic fundamentals over the past few years, as detailed in Table 1.

### Table 1: Macroeconomics, India

| 12 Months to end March | 2002 | 2003 | 2004 | Change (%) |
|---|---|---|---|---|
| GDP* (INRbn) | 20,815 | 22,549 | 25,198 | 11.7 |
| Per Capita Income* (INR) | 19,922 | 21,249 | 23,352 | 9.9 |
| Per Capita PFCE** (INR) | 14,327 | 15,013 | 16,419 | 9.4 |
| Index of Industrial Production | 167.0 | 176.6 | 188.7 | 6.9 |
| WPI (Avg. of 52 Weeks) | 161.3 | 166.8 | 175.9 | 5.5 |

*At current prices and at factor cost
** Private Final Consumption Expenditure per capita
Source: Ministry of Statistics

There has been a substantial increase in private consumption expenditure as well as disposable incomes, driven by growth in *per capita* income.

Fitch expects growth in the number of upper income households to sustain the momentum in the retail industry. With higher growth expected in urban high-income households, the focus will remain on the larger cities. In addition, the surge in consumer credit has also played a part in increasing consumer consumption. According to the Reserve Bank of India ("RBI") retail lending proved the mainstay and a key profit driver for banks over the past few years, with the retail portfolio accounting for 21.5% of total loans in March 2004, or INR1,890bn, which included credit card receivables (INR61.7bn), consumer durable loans (INR62.6bn) and other personal loans (INR871.7bn); the remainder comprised housing loans.

### Table 2: Income Distribution

| Households (m) 12 Months to end March | 1996 | 2002 | 2007e | CAGR (%) |
|---|---|---|---|---|
| >INR215,000 p.a. | 1.2 | 2.6 | 5.2 | 14.9 |
| Urban (%) | 66.7 | 73.1 | 76.9 | |
| INR45,000-INR215,000 | 32.8 | 46.4 | 75.5 | 10.2 |
| Urban (%) | 50.6 | 57.1 | 54.0 | |
| INR22,000-INR45,000 | 54.1 | 74.4 | 81.7 | 1.9 |
| INR16,000-22,000 | 44.0 | 33.1 | 20.2 | -9.4 |
| <INR16,000 | 33.0 | 24.1 | 16.5 | -7.3 |
| **Total** | **165.1** | **180.6** | **199.1** | |

Source: The Marketing White Book 2003-04

### Table 3: Credit Card Statistics in India

| 12 Months to end March | 2003 | 2004 | Change (%) |
|---|---|---|---|
| Transaction Volumes (000) | 44,559 | 97,405 | 119 |
| Transaction Value (INRm) | 75,538 | 172,680 | 129 |
| Avg. Transaction Size (INR) | 1,695 | 1,773 | 5 |

Source: Reserve Bank of India, Market Sources

The increased penetration of credit cards is likely to have a positive impact on the retail industry, given:

- increased consumer expenditure due to interest-free credit periods offered by credit card issuers;
- greater ease of purchase;
- meaningful data on consumption patterns resulting in customised inventory stocking by the retailer and hence, improved efficiencies;
- valuable data for manufacturers on consumer preferences and demographics; and
- greater operational efficiency, i.e. reduced checkout times, etc, at the store level.

Realising the importance of credit cards, retailers are teaming up with credit card issuers to offer special incentives to co-branded cardholders. Examples include the Shopper's Stop/Citibank First Citizens card and the Big Bazaar/ICICI Bank co-branded card.

## Market Size Estimates

The total domestic retail market was estimated at around INR9,300bn in FY04 and growing at 4%-6% p.a. in real terms. Organised retail has benefited from

increased consumption expenditure as well as a shift in preference to organised channels, from around 1% in 1999 to nearly 3% in 2004 (broadly around INR280bn). While the total Indian retail sector has grown in line with private consumption, organised retail has grown at substantially higher rates.

Given the positive outlook for local economic fundamentals, India's retail sector is expected to witness an increasing shift towards organised formats. Market estimates indicate annual growth in the region of 25%-30% p.a. in the short- to medium term, or 8%-10% of total retail sales by FY10.

## ■ Market Structure

As in the case of most developing countries, a substantial proportion of household expenditure in India goes on essentials. Typically, as standards of living improve, consumption moves towards discretionary items such as services, apparel, footwear, durables and other lifestyle products.

**Table 4: Consumption Patterns**

| | India 2004 | Malaysia 2002 | Thailand 2002 |
|---|---|---|---|
| Per Capita Income (USD) | 478 | 3,540 | 2,000 |
| Food, Beverages, Tobacco (%) | 44 | 37 | 37 |
| Clothing & Footwear (%) | 5 | 3 | 4 |
| Consumer Durables, Furniture, etc. (%) | 4 | 5 | 5 |
| Rent, Power, Fuel (%) | 10 | 22 | 21 |
| Medical (%) | 6 | 2 | 6 |
| Services (%) | 6 | 6 | 5 |
| Transport, Communication, etc. (%) | 17 | 19 | 18 |
| Others (%) | 10 | 6 | 5 |

Source: Market Sources

Reflecting the trends in consumption expenditure, organised retail remains concentrated within just a few sectors like groceries and apparel. However, this is changing, with discretionary categories e.g. consumer durables, electronics and furniture, playing an increasingly important role.

Indian retail continues to be dominated by individual, small-format stores with floor space of <500 sqft (many are <100 sqft). The total number of retail outlets is disproportionate to the population, estimated at around 12 million-15million, implying a retail density of around 12-14 outlets per 1,000 people, resulting in a highly fragmented market and small scale of operations.

**Table 5: Organised Retail Composition**

| Estimates for the 12 Months to end March 2004 | (%) |
|---|---|
| Clothing & Textiles | 39 |
| Food & Groceries | 11 |
| Footwear | 9 |
| Jewellery & Watches | 7 |
| Consumer Durables (Electronics, Mobile Phones, etc) | 12 |
| Books, Music & Gifts | 3 |
| Health & Beauty | 3 |
| Catering services/ Eating out | 7 |
| Others (Home, furnishings, entertainment, etc) | 10 |

Source: Market Sources

The major players in Indian retail can be divided into two broad categories:

- Third-party retail service providers (organised and unorganised); and
- Manufacturers undertaking forward integration to gain access to their end-customers.

**Table 6: Types of Retailers**

| Retailer Category/ Nature of Purchase | Product Examples | Retailer Type |
|---|---|---|
| Lower Involvement<br>High Frequency<br>High Price Sensitivity | FMCG, Food & Groceries, Convenience Items | Third-party Retailer |
| High Involvement<br>Medium Frequency<br>Medium Price Sensitivity | Apparel, Footwear, Small Appliances | Third-party Retailer + Manufacturer Driven |
| High Involvement<br>Lower Frequency<br>Brand Conscious | Expensive Durables, Watches, Branded Jewellery | Manufacturer Driven + Emerging Third-party Players |

Source: Fitch

Historically, given the lack of organised retail, manufacturers invested heavily in developing proprietary retail networks. Examples include branded clothing manufacturers such as Indian Rayon, ITC (Wills Sport) and Arvind Mills; durables manufacturers such as LG, Samsung and Sony; and branded jewellery/luxury goods manufacturers such as Titan and Intergold. With the substantial growth in third-party retailing, manufacturers are increasingly teaming up with retailers to augment their distribution networks.

This report focuses on pure third-party retailers, and emerging trends in the industry.

## ■ Evolving Formats

Indian retailers are still experimenting with the various modern retail formats; as highlighted in Table 7.

**Table 7: Evolving Formats**

| Formats | Category | Examples |
|---|---|---|
| **Supermarket Chains** | Food & Groceries, FMCG, Convenience Goods | Nilgiris, Foodworld, Food Bazaar, Apna Bazaar, Trinethra |
| **Department Stores** | Apparel, Accessories, Lifestyle Products | Shopper's Stop, PRL, Ebony, Globus |
| **Seamless Mall** | Apparel, Accessories, Lifestyle Products, Entertainment Services | Central |
| **Speciality Stores** | Product Focus: Durables/Books & Music/ Entertainment | Vijay Sales, Viveks, Planet M, Musicworld, Crossword, The Home Store |
| **Hypermarkets** | Apparel, Food & Groceries, Household Items | Big Bazaar; Spencer's (earlier called Giant, from RPG) |
| **Wholesale / Cash & Carry** | Apparel, Food & Groceries, Household Items | Metro Cash & Carry GmbH, Radhakrishna Foodland |
| **Convenience Stores** | Others | Convenio; In & Out. |

Source: Fitch

Within these broad formats, there are various specialised sub-formats.

- Supermarkets: Stand-alone supermarkets, such as Monday to Sunday, Rustomji's; and Discount supermarket chains like Subhiksha, Margin Free.
- Department stores: Stand-alone department stores such as Big Jo's, Kemp Fort.

### Profit Models, Cost Structures & Characteristics

The profit models differ markedly across the various formats. The key profit models followed by the major retailers are described in Table 8, though operating margins for retail as a whole are low.

**Table 8: Profit Model**

| | Product Variety | Volumes & Footfall | Gross Margin * | Over-heads | Retail Area |
|---|---|---|---|---|---|
| Hypermarkets | H | H | L | H | H |
| Discount Stores | M | L | L | L | L |
| Supermarkets | M | M | M | M | M |
| Department Stores | H | M | H | H | H |
| Unorganised Players | L | L | L | L | L |

Key: H High; M Medium; L Low; *refers to net sales less cost of materials %
Source: Fitch

Profit models and cost structures differ widely across these formats. For instance, the profitability of hypermarkets is primarily driven by high volumes and footfall, while department stores focus on increasing the average customer spend.

Speciality retailing has emerged as an important segment within organised retailing in recent years, with the players focusing on exclusive product categories. Key examples include Oyzterbay (jewellery), Planet M (music), and Vijay Sales and Viveks Ltd (durables), among many others.

Details of emerging trends in the prevailing formats, and critical success factors are given in Appendix 1.

## ■ Other Key Industry Trends

### Supply Chain Initiatives

Given the low-margin nature of the business, retailers are increasingly seeing the need to invest in efficient sourcing and supply chain management to bring down costs. This is particularly true in the fresh foods category as the cost of the product multiplies by the time it reaches the retailer, reflecting significant inefficiencies in the supply chain.

While retailers have been working on reducing the number of intermediaries, large investments, like in cold storage facilities, have yet to be seen but are likely once retailers have built up sufficient scale to justify the cost. Fitch believes that, until then, the focus of the retailers will be on improving internal sourcing processes such as investments in ERP (Enterprise Resource Planning)/inventory management systems, distribution warehouses, etc.

Although some retailers such as Trent Ltd ("Trent"), have invested in a complete ERP package to optimise inventory management, many typically continue to use proprietary systems customised to their specific requirements. While these solutions developed in-house may be sufficient to meet their current needs in the medium- to long term, as retailers expand their scale of operations, they may have to invest in higher-end solutions.

### Private Labels for Margin Enhancement

Private labels are brands created by retailers, and products sold under these brands are comparable in quality to the available branded products. Retailers typically outsource the manufacturing of these products, and as they are bought at lower prices, retailers are able to pass on the cost savings to the consumers while still generating higher margins than on comparable branded products. The largest incidence of private labels has been in apparel retailing, led by the department stores including

Lifestyle, Ebony, Globus, Shopper's Stop and PRL. Indeed, at PRL and Trent, private labels have accounted for as much as 75%, and even virtually 100%, respectively, of total clothing sales. Further, in the food & groceries category, retailers have introduced private labels in packaged cereals and essentials, areas in which Foodworld Supermarkets Ltd and Nilgiris were the pioneers.

Big Bazaar has launched FMCGs (fast moving consumer goods) such as detergents and soaps, under its proprietary Cleancare and Cleanmate brands. Trent has begun selling private label durables in its Star India Bazaar hypermarket. Additionally, Big Bazaar and Viveks have also recently introduced small appliances under private labels, e.g., rice cookers, and grinders. However, these lines were only recently introduced and have yet to make a substantial contribution to sales.

### Mall Developments Alleviating Real Estate Availability Pressures

Availability of retail space has historically been a growth constraint for Indian retail. Although the recent increase in mall development has, to a certain extent, increased supply, high rents in these malls has had a dampening effect.

Retailers have typically followed two models of financing real estate requirements; outright purchase or lease. Most have typically used leases (both operating and financial) to minimise the initial outlay required and enhance financial flexibility.

**Financial Leases**

- Typically used as a means of financing
- Lessee has virtual ownership of the asset
- Operational risks fall to the lessee
- Typically non-cancellable/full payout
- Net lease, i.e. typically no associated services provided, e.g. common area maintenance etc.

**Operating Leases**

- Lessor retains ownership of the asset
- Wet lease: includes the provision of related services.
- The operational risk falls to the lessor
- Developers currently offer non-cancellable operating leases called hybrid leases.
- Can be cancelled/non-full payout

Retailers use financial leases as an additional means of financing, usually from reputed real estate financiers. HDFC Ltd has a large presence in the retail real estate leasing sector, however, with the increase in malls, many of the developers have leased out a portion of their real estate on operating leases. Many malls have also offered other services, e.g. uninterrupted electricity, common area maintenance and other amenities under what are known as wet leases. In addition, given the long-tenor requirement of most retailers, combined with the high initial costs of opening a store, some real estate developers offer hybrid leases i.e. operating leases with a long non-cancellable period.

Further, retailers typically opt for longer-term leases for the following reasons:

- in addition to the lease charges, the high quantum of initial investment they are required to make e.g. in terms of store layout, fixtures, fittings, ambience, etc, are significant, and recouping the costs will take time;
- locations are carefully chosen beforehand, with factors such as expected footfall and catchment area taken into account; and
- the high costs of relocating.

While the majority of new malls are expected to be in the larger cities, some Tier-II cities such as Kanpur, Bhubhaneshwar, Baroda, etc, are also housing some development, albeit on a smaller scale. Growth is expected to bring down rental costs for retailers which, combined with higher footfall, will result in improved efficiencies. Estimates indicate that 93 new malls are expected to become operational by the end of 2006 in the 14 largest cities, with total additions to retail floor space estimated at around 28 million sqft However, mall developments are ultimately expected to extend to smaller cities and towns, though the average size of these malls is likely to be substantially smaller than those in the larger cities but should increase the penetration of organised retail.

Additional retail real estate options are likely to benefit retailers by increasing avenues for expansion, both in terms of location and, potentially, reduced rental costs. However, pockets of high concentration of new mall developments in certain locations e.g. in some suburbs of Delhi, such as Gurgaon, remain a cause for concern.

## ■ Performance of Key Retailers

The rapid expansion in India's retail industry is borne out by the substantial growth in size and scale of the major retailers' operations, details of which are given in Appendix 2.

### Revenue and Profitability Trends

As the retailers have grown in scale, operational efficiencies have improved substantially. Shopper's Stop and Trent have moved from operating losses (EBITDA excluding non-operating income) to profit from FY02. Their key performance metrics are summarised in Table 9.

**Table 9: Operating Trends of Key Retailers**

| (INRm) | FY02 | FY03 | FY04 | Latest Results* | 3 Yr CAGR (%) |
|---|---|---|---|---|---|
| **Shopper's Stop** | | | | | |
| Operating Income | 2,464 | 3,015 | 4,036 | n.a. | 23.0 |
| Growth (%)** | 14 | 22 | 34 | n.a. | |
| Cost of Materials | 1,763 | 2,086 | 2,712 | n.a. | |
| Contribution (%) | 28 | 31 | 33 | n.a. | |
| EBITDA | 93 | 202 | 236 | n.a. | |
| Other Income | 9 | 1 | 2 | n.a. | |
| Op. EBITDA (%) | 3.4 | 6.6 | 5.8 | n.a. | |
| Inventory Turns (x) | 10.1 | 8.3 | 8.0 | n.a. | |
| **Trent Ltd** | | | | | |
| Operating Income | 714 | 1,047 | 1,490 | 1,711 | 29.0 |
| Growth (%)** | 73 | 47 | 42 | 49 | |
| Cost of Materials | 313 | 503 | 707 | 822 | |
| Contribution (%) | 56 | 52 | 53 | 52 | |
| EBITDA | 95 | 124 | 211 | 198 | |
| Other Income | 86 | 77 | 113 | 69 | |
| Op EBITDA (%) | 1.2 | 4.5 | 6.6 | 7.5 | |
| Inventory Turns (x) | 6.3 | 6.4 | 6.8 | n.a. | |
| **PRL** | | | | | |
| Operating Income | 2,759 | 4,414 | 6,562 | 4,393 | 30.0 |
| Growth (%)** | 56 | 60 | 49 | 51 | |
| Cost of Materials | 1,861 | 3,026 | 4,398 | 2,915 | |
| Contribution (%) | 33 | 31 | 33 | 34 | |
| EBITDA | 230 | 366 | 573 | 410 | |
| Other Income | 2 | 8 | 5 | 13 | |
| Op EBITDA (%) | 8.3 | 8.1 | 8.7 | 9.0 | |
| Inventory Turns (x) | 3.5 | 4.0 | 4.4 | n.a. | |

* Trent: Results for the nine months ended December 2004; PRL: Results for the six months ended December 2004
** Growth over the previous period
Source: Companies' Annual Reports, Centre for Monitoring Indian Economy (CMIE), Fitch Adjustments.

As the industry expands, Fitch believes that key retailers will continue to benefit from improvements in both efficiencies and in turn profitability.

However, with increased competition in the department store and hypermarket formats, margins are expected to continue to come under pressure. Profit growth in absolute terms though, is expected to remain strong given projections of volume and topline improvements.

### Substantial Investments in Growth

Over the last few years, the major Indian retailers have invested heavily in expanding floor space.

**Table 10: Estimated Capex**

| (INRm) | Gross Block Additions in FY04 | Capex Estimates FY05-FY07 |
|---|---|---|
| PRL | 611 | 1,900 |
| Shopper's Stop | 173 | 1,400 |
| Trent | 89 | 1,236* |
| Lifestyle | n.a. | 1,400 |
| Subhiksha | n.a. | 700 |

* Estimates for FY06-FY08. By January, 2005 Trent had already incurred INR49m of expenses for expansion
Source: Companies' Annual Reports, Market Sources, Media Reports

Companies are also increasing their investments in upgrading their delivery back-ends, including ERP systems and warehouses. However, these plans are likely to result in negative free cash flows.

### Funding Patterns

Retailers' access to finance has improved significantly over the past few years, with many new options opening up. While previously they relied primarily on private equity and shareholder funding, they are increasingly accessing the capital markets. Some of the recently announced financing plans are:

- Shopper's Stop is planning an initial public offering ("IPO") to finance its INR1.4bn expansion plan;
- PRL has received financing from Bennet & Coleman in the form of a preferential allotment of INR700m, with a further INR1.2bn capex to be financed through a combination of internally generated funding and debt;
- Trent has announced a INR1.18bn issue of partially convertible debentures, including a non-convertible debenture component of INR656m;
- Lifestyle and RPG are planning to increase their pace of expansion through a combination of internally generated financing and additional funding from their sponsors, the Landmarc Group of Dubai and the RPG Group respectively.

While the primary financing for expansion has, typically, been in the form of equity, players have also increasingly assumed debt to finance their working capital requirements.

The financial flexibility enjoyed by India's retailers has improved significantly over the past few years, improving their credit profiles.

## ■ Outlook

Indian retailing continues to offer significant growth potential; this is likely to translate into improved revenues for the current market participants. As is typical of any high-growth industry, Fitch believes that this sector will see a substantial increase in competition, possibly resulting in margin pressures. Companies gaining an early-mover advantage and that have invested in scaling-up are likely to retain the advantage over later entrants. However, expansion in the medium term is likely to be concentrated in the larger cities.

Nevertheless, several factors, like poor infrastructure in the cities, the absence of uniform tax rates and restrictive real estate legislations, are likely to slow growth. Given government policy has yet to be clarified (as at the time of writing), the industry has been constrained by the lack of FDI. If the regulations are relaxed, FDI in retail could fuel growth in the sector, but conversely could also result in a marked increase in competition.

From April 2005, VAT has been implemented in most Indian states, as a replacement for state-level sales tax. This move is the first step towards a uniform taxation system, which will benefit both retailers and manufacturers. However, in the short term, anomalies such as double taxation due to the continuation of Central Sales Tax (CST), and in the case of trade between VAT compliant and non-VAT states will arise. However, on complete implementation, all parties will reap substantial benefits.

From a rating perspective, the larger companies, like PRL and Shopper's Stop, have gained the critical mass required to remain strong contenders in the Indian retail sector. Their ratings, however, are currently constrained by the industry having yet to mature, and pressure on cash flows due to ambitious investment plans is likely to continue.

Retailing/India
Company Update

# Shopper's Stop Limited

### National Rating

**Shopper's Stop Ltd**

| National Rating | Instrument | Rating |
|---|---|---|
| Short-Term | Commercial Paper (INR200m) | F1(ind) |

### Financial Data

**Shopper's Stop Ltd**

| (INRm) | FY04 | FY03 |
|---|---|---|
| Operating Income | 4,036 | 3,015 |
| EBITDA | 236 | 202 |
| Debt/EBITDA (x) | 2.4 | 2.6 |
| Debt-Equity (x) | 0.74 | 0.81 |
| EBITDA Margin (%) | 5.9 | 6.7 |
| EBITDA/ Capital Employed (%) | 19 | 19 |

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**Related Research**
*Fitch Rating Rationale: Shopper's Stop Limited, April 2004, available on www.fitchindia.com*

## Profile

Shopper's Stop, one of the pioneers in Indian organised retail, established its first store in 1991. A part of the C L Raheja Group, whose primary interests are in construction, Shopper's Stop has created a strong brand image, with an extensive network of 15 department stores across eight cities. The Company faced severe operational pressures during FY00 and FY01 following its rapid expansion, resulting in accumulated losses of INR330m in FY01. However, it has taken strong corrective action and has turned around its operations, resulting in profitability at the net level from FY02 onwards. Revenues have grown substantially, from around INR2.5bn in FY02 to over INR4.0bn in FY04; margins also showed similar improvements during the same period.

Shopper's Stop is one of the larger players in the department store segment, and has established a strong national retail brand over the past few years. To enhance its margins, it has focused on developing private labels, currently estimated to account for around 20% of annual sales. The rating factors in the strong brand equity enjoyed by the chain in its existing markets, the demonstrated scalability of its department store format and its professional management team. The rating also considers the company's comfortable liquidity position and low level of debt for its size.

Shopper's Stop is planning to focus on improving its internal systems and processes, including its logistics and inventory management, and now has the requisite infrastructure in place to manage its expansion plans involving an investment of around INR1.4bn, primarily in its retail activities. The bulk of the financing is expected to be raised through its proposed IPO, which is likely to be in Q106.

## Strengths

- Strong brand name.
- Low gearing and improving credit metrics.
- Robust internal processes in place to manage future growth.
- Strong management.

## Concerns

- Achieving profitable growth with new stores.
- Ability to counter competitive pressures on a sustained basis.

Retailing/India
Company Update

# Pantaloon Retail (India) Limited

### National Rating

**Pantaloon Retail (India) Ltd**

| National Rating | Instrument | Rating |
|---|---|---|
| Short-Term | Commercial Paper (INR350m) | F1(ind) |

### Financial Data

**Pantaloon Retail India Ltd**

| (INRm) | Latest Results* | FY04 | FY03 |
|---|---|---|---|
| Operating Income | 4,393 | 6,562 | 4,414 |
| EBITDA | 410 | 573 | 366 |
| Debt/EBITDA (x) | n.a. | 3.9 | 4.2 |
| Debt-Equity (x) | n.a. | 1.92 | 2.02 |
| EBITDA Margin (%) | 9.3 | 8.7 | 8.3 |
| EBITDA/ Capital Employed (%) | n.a. | 17 | 17 |

* Unaudited results for the six months ended December 2004.

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### Related Research

*Fitch Rating Rationale: Pantaloon Retail India Limited February, 2005, available on www.fitchindia.com.*

## Profile

Established by the Biyani family in 1987, PRL is a leading retailer in India with a diversified revenue stream from multiple retail formats. PRL has developed the following models for its retail operations:

- Department stores through Pantaloon stores;
- Discount hypermarkets under the Big Bazaar brand, with the Food Bazaars continuing to operate primarily under the Big Bazaar umbrella; and
- Large format seamless malls, under the Central brand, modelled on global premium department stores such as Selfridges in the UK and Bloomingdale's in the US.

PRL operates 13 Pantaloon stores across eight cities, 13 Big Bazaars across nine cities and seven independent Food Bazaars. The Food Bazaars operate largely under Big Bazaar, though, from FY04, PRL has increased the number of stand-alone Food Bazaars. It has also opened two "Central" malls. FY04 operating income increased by 49% to INR6,562m, with a net profit of INR198m. For the six months ended December 2004, operating income was INR4,406m and net profit INR111m.

PRL has consolidated its brand equity and its early-mover advantage with aggressive additions to its retail space. The rating recognises the ability of the company to maintain profitability in the face of ongoing expansion. Its operational capabilities are reflected in the fact that each of its stores is making an operating profit. PRL is well positioned to capitalise on shifting consumer trends towards organised retail formats. Further, PRL has also focused on enhancing sales of its private label products, which in turn are expected to improve margins. PRL's high reliance on debt to finance its growth remains a cause for concern. That said, the recently announced equity issue is likely to improve its capital structure.

The company has set an aggressive expansion plan, with targeted additional retail floor space of about 1 million sqft in FY05 and FY06, for which it has budgeted an investment of INR1.7bn, to be funded through a combination of debt and equity. Further, PRL has also used the acquisition route for expansion, in businesses such as branded garments, and India's Marks & Spencer's franchisee. The company recently completed a preferential allotment of 953,653 shares of INR10- each at a premium of INR742.02 per share to Bennett Coleman and Company Limited, aggregating to INR700m, which is likely to improve its gearing.

## Strengths

- Strong brand equity and early-mover advantage.
- Positive outlook for organised retailing in India.
- Strong planning and operational capabilities, with the ability to launch successful new formats.
- Fresh equity issue likely to reduce gearing.

## Concerns

- Aggressive expansion plans to maintain leadership in the sector.
- Competition in key segments likely to intensify, especially in hypermarkets.

Retailing/India
Company Update

# Trent Limited

### National Ratings

None

### Financial Data

**Trent Ltd**

| (INRm) | Latest Results* | FY04 | FY03 |
|---|---|---|---|
| Operating Income | 1,711 | 1,490 | 1,047 |
| EBITDA | 198 | 211 | 124 |
| Debt/ EBITDA (x) | n.a. | 0.01 | 0.02 |
| Debt-Equity (x) | n.a. | 0.00 | 0.00 |
| EBITDA Margin (%) | 11.6 | 14.2 | 11.8 |
| EBITDA/ Capital Employed (%) | n.a. | 10.2 | 6.3 |

* Unaudited results for the nine months ended December 2004.

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## Profile

Trent, originally incorporated as Lakme Limited, was one of the pioneers of the Indian cosmetics and personal care market. In 1998, the company divested its entire business to Hindustan Lever Ltd in return for a substantial cash consideration, and in 1999 was renamed Trent, acquiring its first store from Littlewoods, UK, which marked the launch of the Westside brand.

Prior to FY05, Trent focused on the department store format, and from its inception, has focused on establishing its private label range. With a few exceptions, almost all apparel and fashion sales now are from private labels. As a result, the company's gross margins compare favourably with its peers. Trent has achieved profits at the operating level since FY02.

Trent maintained substantial cash balances until FY04 (liquid investments of INR1,134m of in FY04), bringing significant financial flexibility and generating substantial non-operating income. The company has hitherto focused on strategic expansions, and has grown at a slower pace than its peers.

In October 2004, Trent entered the hypermarket segment with the launch of its Star India Bazaar store, of over 50,000 sqft in Ahmedabad, utilising a portion of its surplus investments to establish the store. The hypermarket retail space has hitherto been dominated by PRL through its Big Bazaar format. As it has in its department stores, Trent has planned the rapid introduction of private label sales in various product categories, including consumer durables. However, this initiative is still in its nascent stage, with the first hypermarket yet to complete its first full year of operations.

Trent recently announced a INR1.18bn issue of preferentially convertible debentures to finance the expansion of both store formats. It has drawn up expansion plans aggregating to an investment of INR1,236m between FY06-FY08. Trent's expansion plans involve the establishment of 17 new stores, upgrades of existing stores and the strengthening of the warehouse infrastructure.

## Strengths

- Strong support from parent (the Tata group).
- Favourable financial profile and key credit metrics.
- Strong management.

## Concerns

- Increasing competition and entry into the discount hypermarkets could pressure margins.
- Aggressive expansion focused on the highly competitive hypermarket segment, where the company does not have experience.
- Historically recorded a low ROCE on account of high cash balances.
- Relatively smaller size of operations.

Retailing/India
Company Update

# Foodworld Supermarkets Ltd

### National Ratings

None

### Financial Data

**Foodworld Supermarkets Ltd**

| (INRm) | FY04 | FY03 |
|---|---|---|
| Operating Income | 3,537 | 2,998 |
| EBITDA | 41 | 3 |
| Debt/EBITDA (x) | 4.01 | NM |
| Debt-Equity (x) | 0.50 | 0.72 |
| EBITDA Margin (%) | 1.2 | 0.1 |
| EBITDA/ Capital Employed (%) | 5.4 | 0.4 |

NM: Not Meaningful
Source: Centre for Monitoring Indian Economy

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## Profile

Foodworld Supermarkets Ltd (Foodworld) was founded as a division of Spencer & Co, part of the RPG group, in 1996. In 1999, it was spun off as a separate company under a joint venture with a large international retailer, Dairy Farm International, part of the Jardine Matheson Group. Foodworld remains focused on the supermarket segment within the organised food & groceries retailing segment, and currently has over 90 stores, primarily in southern India. The RPG group also has another venture focusing on hypermarkets, Great Wholesale Club Ltd, which currently operates three hypermarkets in Hyderabad, Vishakapatnam and Mumbai.

The company has invested heavily in improving its supply chain and inventory management systems, attempting to establish a direct relationship with farmers through a pilot contract farming project. However, despite its size (turnover of over INR3.5bn in FY04), Foodworld has been reporting losses at the net level over the past four years, largely due to low gross margins (c.18% between FY02-FY04), and high overheads and interest costs. As a result, its EBITDA/interest ratio was <1.0x during that period. However, gearing remains around 0.50x following an equity infusion in FY03. The company is planning to focus on cost-cutting and rationalising its distribution and administrative overheads over the next few years to improve profitability.

Foodworld plans to expand within the supermarket category by extending its reach and is also currently looking at a low overhead model using small express outlets.

## Strengths

- Financial support from the Group
- One of the largest players in organised food & groceries retailing
- Dominant presence and market share in key markets in southern India

## Concerns

- High gearing compared to profits
- Operations restricted to southern India with no national-level presence
- Yet to report profits

## Appendix 1: Retail Format Analysis

***Hypermarkets***

Their focus is on selling a wide variety of products at the cheapest prices.

In India, the hypermarket format has rapidly gained popularity. The largest players in this segment are Big Bazaar (part of PRL) and Spencer's (part of the RPG Group, through a separate venture, the Great Wholesale Club Ltd; the hypermarkets were earlier branded Giant). Attracted by the growth and profit potential, there have been many new entrants to this sector:

- Trent launched Star India Bazaar in Ahmedabad in October 2004.
- Shop Rite, one of the largest South African retailers, has established its pilot Indian venture in Mulund, Mumbai, through a franchisee arrangement with a local retailer.

The C L Raheja Group has announced plans to enter the hypermarket format through a separate venture, Rainbow Retail, expected to be operational by the end of the current year.

Hypermarket margins vary according to the product mix. While food & groceries typically attract footfall and drive volumes, apparel has the highest margins. While Spencer's has concentrated on food & groceries, Big Bazaar has focused on non-food categories, with food & groceries typically accounting for only c. 25% of sales.

Most retailers are likely to continue expanding in the larger Indian cities and select Tier-II cities with potential for growth. For example, PRL has commenced operations in cities such as Bhubhaneshwar, Nashik and Kanpur.

Fitch believes that the following factors are critical for success in the hypermarkets segment:

- ability to keep real estate and operating costs low, despite the format size;
- sites serve as a destination shopping experience to ensure maximum footfall;
- ability to maintain strict cost control through sourcing advantages and efficient supply chains.

Fitch expects the following trends to characterise the hypermarket format in India:

- rapid growth in revenues led by volumes;
- expansion primarily in the large cities;
- future expansion is likely to be in regions where the retailer already has a presence, to maximise operational efficiencies; and
- competition is likely to intensify as more new entrants are attracted by the rapid acceptance of this format and high growth prospects, possibly resulting in pressure on margins.

***Supermarkets***

This segment has grown over the past few years, but continues to face margin pressures given the higher overheads in relation to store size and sales volumes. Large players operating through these formats include independent Food Bazaars from PRL, Foodworld Supermarkets and Nilgiris Limited, which have followed the model employed by companies in the West, with medium format sizes in prime locations and centralised sourcing.

Within supermarkets, a new "discount supermarket" format appears to be evolving, led by Margin Free in Cochin and Subhiksha in Chennai. Their format and profit models differ from regular supermarkets in that retail floor space is typically smaller, overheads are kept to a bare minimum and only limited ranges are stocked but all products are sold at substantial discounts.

Fitch believes that the following factors are critical to success in the supermarket category:

- proximity to target neighbourhoods;
- price competitiveness specifically with respect to the *kirana* stores and independent stores; and
- ensuring effective cost management without compromising on convenience.

Fitch believes that the following trends are likely to characterise Indian supermarkets over the next few years:

- increased popularity of discount supermarkets, as they will be the first step towards greater acceptance of organised retail by consumers in food & groceries;
- intense competition from large stand-alone stores with similar layouts and product mixes and local *kiranas* for basic requirements, resulting in pressure on margins;
- margins are likely to remain low given the profit model;
- gaining critical mass will be vital to achieving sourcing advantages;
- private labels will become increasingly important to improve margins; and
- the evolution of region-specific variants and value-added services will drive footfall and customer loyalty.

Some examples of value-added services include free home delivery and ordering through an internet site for larger orders. Further, many supermarket

retailers have attempted to tailor offerings to their target markets. Some examples are:

- customisation of store layout and product mix to cater to regional preferences;
- discount pricing strategies (e.g. loss leader staples) and in-store promotions to drive volumes; and
- smaller format "neighbourhood stores" focusing on proximity to maximise catchments, e.g. Trinethra in Hyderabad.

### *Department Stores*

The lifestyle retailing segment, which includes fashion, personal care, branded apparel, etc, has gained importance in Indian retail. Many independent chains have evolved including PRL, Shopper's Stop, Trent (Westside), Globus, and Ebony, but most have followed the model adopted in the West targeting the premium market.

However, region-specific formats continue to exist, with smaller formats being used for the Tier-II cities, while larger formats are used for the major urban centres. In addition, retailers are attempting to differentiate their offerings by evolving alternate formats. For instance, PRL has invested in developing its "Central" format, which essentially functions as a seamless mall along the lines of Selfridges in the UK or Bloomingdale's in the US. Revenues follow a "fixed + variable" fee structure under which the retailer bears the expense of running the mall, ensuring adequate footfall and optimising store-area allocation.

Fitch has identified the following factors for success in the department store category:

- the shopping experience (ambience, store events, displays, product availability, etc) must justify the premium pricing;
- the product mix must be carefully targeted in terms of mix of brands, styles, etc; and
- choice of location (high street/mall), whichever maximises footfall from the target segment.

Fitch expects growth of this format to continue, albeit at a slower rate than the hypermarkets and limited to the larger cities, given the premium nature of the stores. Thus, the scalability of the model is likely to be limited.

### Speciality Retail

Speciality retail has emerged as an important segment in India, the format and size of stores varying according to the nature of the product. Jewellery, durables, books and music have witnessed the strongest growth in recent years.

As customers increasingly look for greater variety, Fitch believes the market offers potential for large, third-party consumer durables retailers. The key challenge in this segment is to build customer loyalty and trust, related to which, retailers use after-sales support and store warranties to increase turnover while simultaneously offering extremely competitive prices.

In the books and music category, large players, such as Crossword (from Shopper's Stop) and Landmark in Chennai, have used large formats, while others, such as Musicworld and Planet M, in addition to independent stores, have used other formats like in-store outlets and kiosks to extend their reach.

While Fitch believes that speciality retail has a future in the long term, growth could be limited by the significant initial investments required, combined with high overheads of managing the stores. Scaling up by the larger retailers is critical to achieve better sourcing advantages, while the evolution of speciality malls, i.e., malls focused on a specific product category, e.g., jewellery, is likely to enhance the growth potential of speciality retail.

**Table 11: Speciality Retail**

| Format Size | Sales / Store | Contrn. Margins | Overhead Cost/ Inventory Value | Success Factors | Examples | Categories |
|---|---|---|---|---|---|---|
| Large | Medium to High Value Low to Medium Volume | Low | High | Customer loyalty and after-sales service are critical<br>Product variety and brand portfolio, and shopping experience are critical<br>Prime locations (malls/ high street)<br>Layout is similar to a department store<br>Rapid scaling-up critical for manufacturer discounts | Vijay Sales; Godrej & Boyce Retail Division | Durables Furniture |
| Medium | High Value Low Volume | High | High/High | Customer trust<br>Styling and design<br>Store ambience, service and experience | Oyzterbay | Jewellery |

Source: Fitch

## Appendix 2: Business Summary of Few Key Retailers in India

| Group/Company | Venture | Format | Stores/Retail Points | FY04 Estimate (INRm)* | Expansion Plans |
|---|---|---|---|---|---|
| RPG Group | Foodworld Supermarkets | Supermarkets | 92 | Sales: 3,537; PBDIT: 33; Gross Block: 577 | • Short term focus on managing overheads<br>• Strong growth across formats in the longer term |
| | Great Wholesale Club Ltd | Hypermarkets | 3 | Sales: 1,500 | • Aggressive expansion plans in hypermarkets |
| | Music world | Speciality (Music) | 203 | Sales: 607 | • Focus on small format expansions |
| | Health & Glow | Speciality (Personal Care) | 28 | Sales: 280 | • Slow growth, niche market. Not a focus area |
| Bennet & Coleman | Planet M | Speciality (Music) | 39 Stores<br>56 Points | Sales: 540 | • Expansion into 100 retail points/ outlets FY05 (E) |
| Rajan Raheja | Globus Pvt Limited | Department Stores | 7 | Sales: 800 | • FY05(E) sales at INR1,000m<br>• Expansion plans of around 45-50 stores over the next three years |
| C L Raheja | Shopper's Stop | Department Stores | 16 | Sales: 4,036; EBITD: 236 | • 22 new stores by FY07 (E)<br>• 10 new stores by FY05 (E) |
| DS Group | Ebony | Department Stores | 9 | Sales: 820 | • Investment of INR400m over the next four years |
| Landmarc Group | Lifestyle | Department Stores | 7 | Sales: 2,300 | • Planned investment of INR1,400m over the next three years<br>• Expand stores to 21, with over 1mn sq ft area<br>• FY05 (E) sales Rs3,100mn |
| Private | Nilgiris | Supermarkets | 28 | ~Sales:1,500; Op. Gross Margins: 15%; Net Margins:2%-5% | • n.a. |
| Private | Trinethra Super Bazaar | Supermarkets | 72 | Sales: 1,070 | • 100 new stores; investment of Rs100mn over the next few years<br>• 3 mini-hypermarkets investment of Rs150mn |
| Private | Subhiksha | Discount Small Format Supermarkets | 164 | Estd. FY05, Sales: 2,250, Estd. NPM of around 2%<br>Estd. FY05, Sales: 2,750 | • 136 new stores by 2006<br>• INR250m additional funding from private equity ICICI Ventures, with total investment of Rs700mn over the next two years<br>• Target sales of INR5,000m p.a. over the next two years |
| Co-Operative | Apna Bazaar | Small Format Supermarket | 80 | Sales: 1,500 | • n.a. |

* In the case of unlisted companies, data is estimated from market sources; Retail points refer to shop-in-shop/ kiosk type of arrangements with other retailers; Source: Market sources, Company reports, Media reports, Fitch estimates.

## Appendix 2: Business Summary of Few Key Retailers in India (Cont/d)

| Group/Company | Venture | Format | Stores/Retail Points | FY04 Estimate (INRm)* | Expansion Plans |
|---|---|---|---|---|---|
| Private | Margin Free | Discount Small Format Supermarkets | 240 | n.a. | • Expand operations using franchisee arrangements |
| Tatas | Trent Ltd | Department Stores | 11 | Sales: 1,490; EBITD: 211; Gross Block: 630 | • 5 new department stores by FY05<br>• Financing plans through issue of preferentially convertible debentures of INR1.18bn announced |
| | | Hypermarket | 1 | | • 17 new stores by FY08 in both Department store and hypermarket segments |
| Rosy Blue Group | Intergold/ Orra | Speciality (Jewellery) | 22 | Sales: 600 | • Investment plan: INR900m for 40 outlets over the next three years; 14 by FY05 (E) |
| Piramals | Pyramid Retail Pvt Ltd | Department Stores | 3 | Sales: 800 | • Investment of over Rs1,000mn across formats over the next three years |
| | | Malls | 2 | | • 12 Pyramid outlets over the next three years |
| Private | Viveks Limited | Speciality (Durables) | 46 | Sales: 2,012 | • 25% growth in FY05 (E)<br>• Additional 100 stores through franchise in the next 2-3 years |
| Kishore Biyani (Pantaloon Retail) | Big Bazaar/ Food Bazaar | Hypermarkets | 13 Hypermarkets<br>7 Food Bazaars | Segment Sales: 3,199; Segment Result: 238 | • 24 new hypermarkets, 8 new department stores and 3 new Centrals totalling 2.3m sq ft by FY06 |
| | Pantaloons | Department Stores | 13 | Segment Sales: 3,419; Segment Result: 385 | • Total planned investment of INR1.9bn |
| | Centrals | Seamless Mall | 2 | Yet to complete the first full year of operations | |

* In the case of unlisted companies, data is estimated from market sources; Retail points refer to shop-in-shop/ kiosk type of arrangements with other retailers; Source: Market sources, Company reports, Media reports, Fitch estimates.