TRAVERS SMITH

KHAITAN &CO
Advocates since 1911

Investing in India

A guide for retailers

December 2012

Investing in India: a guide for retailers

In a bold move, the Indian Government recently made major changes to its Foreign Direct Investment (FDI) rules relating to the retail sector. In this briefing, we look at who can now invest in the Indian retail sector and what restrictions and challenges they face. We also look at the activities of international retailers who already have a presence in India.

"The 'organised' retail sector in India is expected to treble in size by 2020."

Why look at expansion into India?

India has a population of 1.2 billion and a growing and increasingly affluent middle class. Its retail market is already worth $450 billion and is expected to grow even faster than the rest of the economy (which has averaged 8% growth over the past 8 years). But perhaps the most compelling statistic is this one: at present, "organised retail" (i.e. retailers with a recognised brand looking to operate a network of stores) only accounts for 5% of the entire Indian retail market. There is therefore very considerable scope for growth in this particular market segment, which is expected to treble in size by 2020.

What has changed?

Until this year, FDI in the Indian retail sector (as opposed to "indirect" investment by institutional investors via the secondary market) was subject to significant restrictions. In particular, foreign investors could only own up to 51% of "single brand" retail operations and were prohibited from owning or investing in "multi-brand" retail operations. The difference between "single brand" and "multi-brand" is discussed in more detail below. Following the relaxation of the rules, foreign investors can now own:

- up to 100% of "single brand" retail operations; and
- up to 51% of "multi-brand" retail operations.

However, the investment must first be approved by the Indian Government and certain conditions must also be met (see further below).

What are "multi-brand" retailers?

The concept of "multi-brand" is intended to cover retailers such as supermarkets, where many different brands are sold "under one roof"; examples would include Tesco, Walmart and Carrefour. More restrictive rules apply to multi-brand retailers partly because of fears that unrestrained market entry by large multi-nationals would have a severe adverse effect on small traders and shop-keepers. As noted above, these smaller operators still account for the vast majority of the Indian retail sector and the relaxation of the multi-brand rules remains extremely controversial. This is why it is only being introduced gradually, on a State-by-State basis (see box opposite), and some Indian States remain vehemently against it.

In addition to the requirement to source at least 30% of goods purchased from small industries in India, the following conditions apply to FDI in "multi-brand" retail:

- A minimum of US $100 million must be invested - which means that, in practice, the relaxation of the FDI rules for "multi-brand" retailers is only likely to benefit large international businesses;
- Within 3 years of the first tranche of FDI, at least 50% of the total FDI must have been invested in "back-end infrastructure" such as distribution and warehousing (but excluding land cost, rentals and set-up of actual retail premises); and
- Retail sales outlets may only be set up in cities with a population of more than 1 million as per the 2011 Census (subject to certain exceptions for Indian States with lower populations).

Areas of India permitting "multi-brand" retail by foreign investors

Foreign investment in "multi-brand" retail is being introduced gradually in India. So far, the following States and Union (i.e. federally controlled and administered) Territories have agreed to permit it under the FDI rules:

Andhra Pradesh, Assam, Delhi, Haryana, Jammu & Kashmir, Maharashtra, Manipur, Rajasthan, Uttarakhand, Daman & Diu and Dadra & Nagar Haveli.

What are "single brand" retailers?

"Single brand", by contrast, is intended to cover retailers which only sell goods under the retailer's own brand: examples would include Ikea, Burberry and Gucci. Fewer restrictions are imposed as "single brand" retail is less controversial. In particular, there are no minimum levels of investment or requirements to invest in infrastructure. The key condition is that foreign investors must ensure that 30% of goods purchased are sourced from Indian suppliers (see below). However, in practice, many retailers may find it difficult to bring themselves within the concept of "single brand":

- **Branded during manufacture:** single brand retailers may only sell products which have been branded during manufacture. This condition is primarily intended to prevent "multi-brand" retailers effectively exploiting the "single brand" regime by simply relabelling third party goods under their own brand. However, it is likely to be problematic for some sectors such as food and beverage retailers.
- **Sold under the same brand outside India:** single brand retailers may also only sell products which have been sold under the same brand outside India. This is potentially problematic for retailers which sell a range of third party branded products alongside their "core" own brand products. If such retailers wish to benefit from the FDI rules applying to "single brand" retail, they will only be able to sell products from their "core" branded range. Again, the reason for the restriction is concern over the potential for multi-brand retailers to exploit the "single brand" regime.

There is also doubt over whether a foreign entity can own a retail business in India where it has "licenced in" the brand under which it operates from a third party. Much is likely to depend on how the Indian government interprets the concept of "single brand" in practice and clarifications have been sought from the Indian Government.

"The definition of 'single brand' may well be problematic for some retailers."

How far are you obliged to use local suppliers?

There are some potentially quite challenging requirements to use local suppliers:

- "Single brand" retail operations involving foreign direct investment of more than 51% must source 30% of the value of goods purchased from Indian firms, preferably from micro, small and medium enterprises (MSMEs), village and cottage industries, artisans and craftsmen in India.
- For "multi-brand" retailers, at least 30% of the value of manufactured/processed products purchased must be sourced from Indian "small industries" which have a total investment in plant and machinery not exceeding US $1 million.

In the first 5 years of operation, retailers will have some flexibility because the requirement is only to ensure that the average value of goods purchased over that period meets the threshold. However, once that initial period has ended, the condition must be met on an annual basis. Although retailers may self-certify their compliance, their figures must be signed off by statutory auditors. In addition, if a "single brand" retailer is unable to meet the 30% requirement by purchasing from smaller suppliers in India, it may be able to use larger Indian firms (although it remains unclear how far the retailer is expected to go in its efforts to purchase from smaller firms before it can start to look elsewhere).

"Meeting the local sourcing obligations may be challenging without a local partner or good local expertise."

What happens if you are granted consent but fail to meet the conditions?

Although in principle the Indian Government could withdraw its consent to the foreign investment, this is considered unlikely in practice. The most likely sanction to be applied for failure to meet the conditions applicable to foreign investment is a civil fine, which could be substantial (up to three times the amount involved in the contravention, assuming it is quantifiable). Failure to pay the fine could result in further sanctions being applied, including imprisonment.

Do you need a local partner?

For "multi-brand" retailers, an Indian partner is essential since foreign ownership is capped at 51%. For "single brand" retailers, no such restriction applies – but it will often be advisable to either seek a local partner or engage local consultants to assist. For example, foreign retailers may well find it difficult to meet the requirement to source 30% of goods from small Indian suppliers without access to good local knowledge and expertise.

For retailers which are unable to meet the FDI conditions, a local partner – in the form of an Indian franchisee or, in the case of a "single brand" retailer, a joint venture partner – will generally be the only way to enter the Indian market. However, such arrangements would avoid the need to meet the local sourcing requirements and the other restrictions outlined above – so even for retailers which could, in theory, meet the FDI conditions, use of a local partner may offer distinct advantages. As always with such initiatives, however, careful consideration should be given to control/governance rights and exit provisions before proceeding.

Do the FDI rules allow you to set up an e-commerce operation?

Under the FDI rules, Indian companies with FDI are not allowed to engage in retail trading by means of e-commerce (in any form). This applies to both "multi-brand" and "single-brand" retail. However, there is no prohibition on such companies from having an online presence in India, provided that this is only used for marketing purposes (and is not used to make sales i.e. customers cannot order products/services from the relevant website). There is also no restriction on Indian franchisees of foreign retailers engaging in e-commerce.

"Many Western retail groups have been operating in India for some time, using franchising arrangements or joint ventures."

How does the approval process work?

Government approval is required for all FDI in the retail sector. An application must be made to the Department of Industrial Policy & Promotion, Ministry of Commerce and Industry (DIPP), which will determine whether the investment proposal meets the policy guidelines. The application will then be considered by the Foreign Investment Promotion Board (FIPB), which is an inter-governmental agency under the Ministry of Finance. Where the FDI exceeds $225 million, it must also be approved by the Cabinet Committee on Economic Affairs. The entire approval process normally takes 1-3 months. However, for the retail sector, this period could be longer due to the multiple agencies involved.

What are other international retailers doing?

Many Western retailers have been operating in India for some time under franchising arrangements, including Lacoste, Mango and Alfred Dunhill. Other retailers, including Oviesse, Burberry, Mothercare, Delsey, Clarks and Gucci, have been operating with joint venture partners, taking advantage of the previous arrangements allowing 51% ownership of "single brand" retail. Some of these retailers may want to change their current arrangements to take account of the recent changes to FDI rules. Others will want to stay as they are.

Ikea and Pavers England were amongst the first companies to apply for approval to operate single brand operations in India through wholly-owned subsidiaries. DIPP and FIBP have approved the proposal of Pavers England, which is now positioned to be one of the first foreign retailers to trade in India through a wholly-owned subsidiary. Ikea's proposal has been approved by DIPP and is now being considered by FIPB. Ikea has been quoted as saying that it intends to spend $1.5bn in India over the next 10 years. Walmart, Tesco and Carrefour and other well-known international retailers are expected to seek approval to operate multi-brand operations in India. Some of these retailers have already been operating as cash and carry businesses or otherwise supporting retailing operations owned by Indian groups. The franchising or joint venture approach is likely to continue to be attractive where foreign retailers have concluded that the best way to enter the market is with a local partner (even though this is no longer a requirement for "single brand" retail).

What are the tax implications?

Companies incorporated in India (with or without foreign investment) are treated as domestic corporations and are required to pay tax at the rate of 32.45% on their business income. A foreign company incorporated outside India which derives income from India is required to pay tax at a much higher rate of 42% of its business income derived from India. Dividend income is not taxed in the hands of a shareholder (whether Indian or foreign) although an Indian company paying dividends is required to pay a dividend distribution tax of 16%. Investors can take advantage of favourable tax treatment, particularly on capital gains arising on a share transfer, under Tax Treaties with countries like Mauritius, Singapore and Cyprus by making investments in the Indian retail sector through these countries.

"Investors can make use of favourable tax treatment."

India's indirect tax system, meanwhile, is multi-layered with levies both at the Union and State levels. Foreign investors should note that customs duty on the import of lifestyle goods and luxury items can be high. For example, the import duty on wine and spirits and cars is just over 160% of their transaction value. On the other hand, import duty on clothing, shoes, watches and jewellery is considerably lower at a maximum of 29% of their transaction value.

At the State level, value added tax (VAT) is levied on local sales with rates that vary between 4%-5% and 12.5%-14% on the value of goods sold. Other local taxes like entry tax, luxury tax etc may also apply.

What is the reputational risk?

As noted above, entry into the retail market by major "multi-brand" retailers is extremely controversial in India because of concerns over the impact on smaller traders. It follows that there is likely to be some reputational risk for those retailers. "Single brand" retail is less controversial, as evidenced by the less onerous restrictions on foreign investments. India is still a developing economy and other types of reputational risk should also be considered. US and European retailers, for example, will want to ensure that they have appropriate compliance measures in place to protect themselves against liability under anti-bribery laws (both in India and in their "home" jurisdictions).

India: facts & figures

- **Population:** 1.2 billion
- **Average growth rate:** 8% (over past 8 years)
- **Retail market size:** $450 billion by value

What's in it for the Indian Government?

The Indian Government is keen to ensure that India's economy continues to grow rapidly and sees retail as a key sector in achieving that goal. It is also looking to the retail sector to drive improvements in the supply chain. For example, it is often said that more than 30% of all produce grown in India simply rots or otherwise goes to waste; poor distribution infrastructure means that many farmers cannot get their produce to the consumer. The hope is that international retailers (particularly "multi-brand" retailers such as Tesco, Carrefour and Wal-Mart) will bring their money and expertise to bear on the supply chain – which will have significant wider benefits for the Indian economy.

What are my options if I can't meet the FDI conditions?

As explained above, there are likely to be some retailers for whom meeting the FDI conditions is either impossible or impractical. For these businesses, the main option in the short term is to pursue the franchising route or, in the case of a "single brand retailer", the joint venture, route with an Indian partner.

Contacts

TRAVERS SMITH

Tom Purton, Head of Commercial, IP and Technology
Email: tom.purton@traverssmith.com

Sonal Patel, Corporate Associate
Email: sonal.patel@traverssmith.com

Travers Smith LLP
10 Snow Hill
London
EC1A 2AL
UK

T: +44 20 7295 3000
F: +44 20 7295 3500

www.traverssmith.com

KHAITAN & CO
Advocates since 1911

Haigreve Khaitan, Partner
Email: haigreve.khaitan@khaitanco.com

Rabindra Jhunjhunwala, Partner
Email: rabindra.jhunjhunwala@khaitanco.com

Khaitan & Co
One Indiabulls Centre, 13th Floor, Tower 1
841 Senapati Bapat Marg
Elphinstone Road
Mumbai 400 013, India

T: +91 22 6636 5000
F: +91 22 6636 5050

www.khaitanco.com