It's time to catch the FDI bus

By Harminder Sahni

EVEN AS POLICYMAKERS AGREE THAT MODERN RETAIL IS GOOD FOR ALL CONCERNED, INCLUDING FARMERS, RETAILERS AND CONSUMERS, THE CURRENT FDI POLICY DISALLOWS OR LIMITS THE SCOPE OF FOREIGN INVESTMENT IN THE FAST-GROWING SECTOR. HOWEVER, SOONER OR LATER, THEY WILL HAVE TO OPEN IT, AS MODERN RETAIL IN INDIA CANNOT GROW TO ITS FULL POTENTIAL WITHOUT AN OPEN INVESTMENT POLICY. WHAT ARE WE WAITING FOR?

→ Indian retail has seen more changes over the last 10 years than it saw in the last 100 years or more. In fact, modern retail is so recent that even its definition is yet to be agreed upon. Anyway, if we have to define modern retail, we all may agree that modern retail is a chain of stores that allows consumers to browse and has some level of sophistication at the back end for buying, stocking and replenishing. And that's the kind of modern retail that has arguably taken six per cent of the market share in the overall Indian retail sector over the last 10 years, and is expected to take more than 20 per cent in the next 10 years. This huge jump in share will require significantly large investments at the front end as well as the back-end by current Indian and international retailers.

I see that the restrictive FDI policy will be the biggest hurdle in the investment in this sector. The current policy not only hinders investments by international retailers, but also indirectly disallows Indian companies to make large investments in the sector. The FDI policy is working like a multi-pronged sword in case of Indian retail.

First of all, most Indian conglomerates that are keen on diversification prefer industries where they can get a foreign partner to invest along with or they are able to sell a part to an international partner at a huge premium soon enough. FDI policy for retail discourages such investments and, hence, is a deterrent for many interested Indian business houses who then invest in sectors such as insurance, telecom, financial services, etc where the policies are more favourable.

The rationale for diversified groups is very simple, as their intent is to create value, release their equity or leverage it to enter another business or fuel growth of the most attractive business in their portfolio. The domestic M&A market is still very small and joint ventures between Indian companies are rare events and even rarer to survive. Hence, the only exit option is through selling off companies either fully or partly to international investors. Until the FDI policy allows that, most Indian business houses will either stay away from this sector or invest far lower than their capacity as well as the demand of the sector.

Secondly, no big international retailer will invest serious amounts of money in India, unless they have full clarity on the future policy of their ownership. Some of the investments that have come in the last few years in the back-end and in wholesale, look big in relative terms, but in reality are really small, given the size of the companies that are making these investments and the potential they state the Indian market holds for them. And we can't blame these companies either, as they are large public limited companies or answerable to all stakeholders, so they won't make investments on the basis of their hunch or perception. Also, due to the restrictive policy, many retailers are investing in wholesale (cash and carry) businesses, where FDI is allowed. The fact is that most of these companies have never been in the wholesale business in their countries of origin or other markets they are operating in. Thus, these companies are not only trying to understand a new market, but are also trying to create a completely new business model from scratch. There is no doubt in my mind that most of these companies would not have tried to do so if they were allowed to launch the businesses that they have mastered over the decades. The FDI policy has taken away their fundamental advantage and this obviously has restricted their appetite for risk and capability to invest.

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These policymakers, while lauding themselves for having found a middle path, have actually created a chasm that many international players may be falling into unintentionally.

I must mention here that I don't believe large international retailers will source more from India if they are allowed to invest in front-end retail. The global retail market is so competitive that if Indian suppliers were globally competitive, these international retailers will buy from India, regardless of their presence in front end retail or not. If this argument was true, then Bangladesh would not have become a larger garment exporter than India, as the number of international brands and retailers present in India is much higher than in Bangladesh.

International retailers wish to come to India as we offer a large and fast-growing consumer market and the policymakers need to ensure that we don't miss out on this huge FDI opportunity. The continuing slowdown in consumer demand in the developed world may force international retailers to come to India, even if the policy is not as open and flexible as they wish it to be. But in its current form, where no FDI is allowed in front end (except for up to 51 per cent in single brand retail), it's making it impossible for them to invest, despite best intentions to do so.

Thirdly, the current FDI policy disallows investment not only by international retailers, but also by FIIs (foreign institutional investors) such as venture capital and private equity funds in Indian retail. The worst hit from this policy are the start-ups and early stage businesses. Retail by nature is a high capex and long gestation period business and hence out of reach for most entrepreneurs. The major contradiction to this is that it's a very low entry barrier business. Anyone can start a couple of stores with limited amount of capital, but to be able to

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scale it up and set up a proper retail management organisation and back end requires serious amount of capital. Unfortunately, many entrepreneurs got on to the retail band wagon and started small, hoping they would find funding for growth. Their dreams went sour when they realised that only Indian funds could invest in their businesses. First of all, there were very few funds anyway and not many of those were interested in investing in retail. Hence, it left a few funds in a sort of monopoly position where they drove down the values, and the entrepreneurs who were desperate ended up giving away too much equity for too little money. It discouraged many others and, hence, either they stayed small and withered or simply disappeared. The number of start-ups that have closed down have not been accounted for, but the count my run into dozens. It's not that they weren't good business models or the management teams were not competent, it is just the lack of capital at right valuation that killed so many of these at early stages. The number of retail ideas that didn't go beyond the business plan is another story.

The counter argument that runs in favour of the current FDI policy is that it has not discouraged large Indian companies, international retailers or even FIIs from making investments in this sector. And it's true that many of the above mentioned entities have made significant investments even in the recent past, post the recent economic slowdown. Such examples are cited often enough to support the continuation of the current policy or for allowing only minor concessions.

There is a saying in science circles that "absence of evidence is not an evidence of absence". I believe this is what is being challenged here. There's no way to establish how much investments could have happened in modern retail if the FDI policy was more favourable and encouraging, but there is enough reason to believe that it would have been far more than what it has been so far.

I wonder whether policymakers will accept the inevitability of modern retail in all Indian markets and not question its valuable contribution to the Indian consumer market and start working towards ensuring faster growth by offering full support in all forms and specifically by allowing more capital to flow in to the sector.

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The first and immediate step that policymakers can take is to allow FIIs (only VC and PE funds) to invest in retail. While I would like it to be fully open and with no restrictions of any kind, policymakers may at least allow this for the start-ups and early stage retail businesses. The policy can put some guidelines in terms of size and nature of business, disallowing sales of shares to other retailers, etc. But something needs to be done otherwise; the Indian retail sector will remain dominated by large local players and be dependent on them for its growth. Then suddenly one day the policy may be changed to allow large international retailers to come in and either invest and/or acquire local retailers. It will ensure that the Indian retail sector will, from the very start, be in a consolidated state and will curb innovation and entrepreneurship.

By allowing FIIs to support start-ups, the sector will see a lot of creativity and innovation at the grass-roots level and less of straight copying of western formats by large players. Even in such a constrained environment, if a Future Group could emerge on the Indian business horizon, then a reasonably favourable policy may allow many more Biyanis to join the ranks of the Ambanis and the Armanis.

The policymakers have to accept that modern retailing is good for all concerned – consumers, farmers, manufacturers, real estate, tax collections – and, thus, they need to enable its faster growth and allow investments from all sources to happen in this sector. ☒

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