KPMG

Consumer Markets in India – the next big thing?

CONSUMER MARKETS

AUDIT ▪ TAX ▪ ADVISORY

Contents

Recent times have seen an awakening of interest in what India has to offer to global businesses. With the increased sources of information available, it can often be difficult to base business decisions on any information whose veracity is questionable.

The KPMG firm in India together with the Indian Market Research Bureau (IMRB) undertook some research focusing on the opportunities and challenges for consumer markets companies doing business in India.

The original research for this study followed a dual approach:

- identifying a select number of decision makers and opinion leaders across the leading companies of the country; and

- taking qualitative and quantitative inputs from these industry leaders.

In addition to the first-hand opinions of leaders and executives from leading Indian and multinational companies, the report includes research from trusted sources like industry bodies and the government, as well as data from other sources in the public domain.

Consumer Markets in India – the next big thing?

Executive summary

India represents an economic opportunity on a massive scale, both as a global base and as a domestic market.

Regulatory controls on foreign direct investment (FDI) have relaxed considerably in recent years. However, while retailing currently remains closed to FDI, this is an area of ongoing debate. This means that foreign retailers and consumer goods manufacturers can only participate in the retail market through indirect access strategies, such as wholesaling, franchising or licensing, or by having a manufacturing base in India, or in businesses upstream of retailing. However, the Indian government has indicated in 2005 that liberalization of direct investment in retailing is under active consideration.

Price controls have been progressively liberalized since 1992, but a small number of items remain fully controlled. There are also extensive controls on packaging, labeling and certification.

Many of the companies surveyed believe that the potential size of this market is underestimated.

Estimates of the size of the retail sector vary, with recent calculations putting the annual value of Indian retailing anywhere between US$180 billion and US$292 billion in 2003.[1] The retail sector is largely made up of what is known in India as the unorganized sector. This sector consists of small family-owned stores, located in residential areas, with a shop floor of less than 500 square feet. At present the organized sector (everything other than these small family-owned businesses) accounts for only 2 to 4 percent of the total market although this is expected to rise by 20 to 25 percent by 2010.

Many of the companies surveyed believe that the potential size of this market is underestimated. They consider that there are considerable opportunities for organized retailers in the kind of rural territories that many companies have failed to address. A critical issue is how fast and how far the consuming class will grow. This depends both on the growth of personal disposable income and the extent to which organized retailers succeed in reaching lower down the income scale to reach potential consumers towards the bottom of the consumer pyramid.

Companies expect retail growth in the coming five years to be stronger than GDP growth, driven by changing lifestyles and by strong income growth, which in turn will be supported by favorable demographic patterns.

The structure of retailing will also develop rapidly. Shopping malls are becoming increasingly common in large cities, and announced development plans project at least 150 new shopping malls by 2008. The number of department stores is growing much faster than overall retail, at an annual 24 percent. Supermarkets have been taking an increasing share of general food and grocery trade over the last two decades.

[1]Source: EIU Country Briefing on India, 2005.

Consumer credit will also grow, assisted by the likely fall in retail lending rates and more efficient and consumer-friendly lending practices.

Distribution continues to improve, but it still remains a major inefficiency. Poor quality of infrastructure, coupled with poor quality of the distribution sector, results in logistics costs that are very high as a proportion of GDP, and inventories which have to be maintained at an unusually high level.

Marketing and advertising are of increasing interest and concern to consumer companies. Indian consumers are becoming increasingly sophisticated and knowledgeable about products; media channels that allow companies to communicate with consumers are growing in diversity and reach. Foreign brands remain very powerful in India, especially in clothing and personal care products, but increasingly brands have to be associated with value. Advertising is becoming a bigger part of the marketing mix – companies are concerned about identifying consumer insights and the profusion of media channels.

All companies agree: Indian consumer markets are changing fast, with rapid growth in disposable incomes, the development of modern urban lifestyles.

Food and beverage offer the greatest organized retail growth opportunities, say companies. The main growth opportunity in the segment is in processed foods: rapid growth in the processed food segment is already apparent, changing lifestyles and food habits are resulting in the rapid expansion of branded food outlet and café chains.

Gemstones and jewelry represent the most significant specialist segment of Indian retailing. Organized jewelry retailers are increasingly offering brand solutions to the demand for quality and value, as consumers move away from traditional retail settings reliant on family retailers.

All companies agree: Indian consumer markets are changing fast, with rapid growth in disposable incomes, the development of modern urban lifestyles, and the emergence of the kind of trend-conscious consumers that India has not seen in the past. "Indians are traveling abroad a lot more," says a representative of an industry association. "They get exposed to what is happening in other markets, they bring back new attitudes and preferences."

But with those changes, companies are adamant that while there are growth opportunities for consumer companies, there are few easy pickings. "You can't sell junk in India," says a senior manager in a leading fashion company. "It is not like worldwide fashion, where people might wear a garment three or four times and then discard it. In India you have to give value."

Indian companies know Indian markets better, but foreign players will come in and challenge the locals by sheer cash power, the power to drive down prices. That will be the coming struggle.

Companies are also increasingly keen to bring organized retailing to unvisited parts of the economy. “We think the best opportunities are in rural markets,” says a leading shoe retailer. “Our whole strategy is to penetrate the rural market.”

Distribution remains the biggest challenge companies face, not least because India’s transport infrastructure remains weak. “Understanding the consumer, understanding the marketing environment, these are challenges, but distribution is the biggest issue,” says a personal care products company. A leading watch and jewelry company agrees: “Distribution and marketing is a huge cost in Indian consumer markets. It’s a lot easier to cut manufacturing costs than it is to cut distribution and marketing costs.”

Companies expect that the next cycle of change in Indian consumer markets will be the arrival of foreign players in consumer retailing. Although FDI remains highly restricted in retailing, most companies believe that will not be for long. “The very fact that politicians have left the issue open leads us to think the restrictions are going to be reviewed,” says a leading sportswear manufacturer. And if retailing is liberalized, say companies, growth will be boosted, but so will competition. Says a leading shoe retailer: “Indian companies know Indian markets better, but foreign players will come in and challenge the locals by sheer cash power, the power to drive down prices. That will be the coming struggle.”

Introduction

India is undergoing unprecedented change. It is one of the fastest-growing large economies in the world, with a population of around one billion people, with huge human and natural resources, and with costs that are at the very low end of the global average. India has its dominance in the IT industry with this being a base for almost all the leading IT companies in the world. India's large English-speaking population certainly enhances it as an attractive business destination. India represents an economic opportunity on a massive scale, both as a global base and as a domestic market.

It is also an opportunity that India is anxious to grasp. Emerging from decades of economic isolationism, India's reform process is now bringing this billion-person economy into the global arena. In a recent interview with The McKinsey Quarterly, India's Prime Minister Manmohan Singh said "If I have any message, it is that it is our ambition to integrate our country into the evolving global economy. We accept the logic of globalization." [1]

India has grown at over 5 percent over the last five years. In unadjusted U.S. dollar terms Indian growth dipped soon after the millennium, reflecting not only the world growth downturn that hit bottom in 2002 but also the exceptionally severe drought that hit India in that year. But it is estimated that the economy will expand by almost 7 percent in 2005 and by the same amount in 2006, with growth being driven primarily by improvements in infrastructure and increased private consumption. Compare that to European growth of less than 2 percent on a 10-year average, and U.S. growth of around 3 percent: on these trends India will be one of the world's biggest two economies by mid-century.

Yet despite this rapid growth, consumer markets in India remain largely untapped and relatively undeveloped, although that is changing fast. This is in part the legacy of 40 years of relative isolation from the global economy, as postcolonial India attempted to build a self-reliant economy behind high tariff walls that discouraged foreign investment.

Much has changed since the government of Rajiv Gandhi began the long, slow and painful process of opening up the economy. Over the 1980s the average growth rate rose from 3.5 percent to over 5 percent, and a financial crisis in 1991 prompted a bigger and faster deregulatory reform package with cuts in trade taxes and sell-offs in the state-owned economy. Gradually, India's consumer markets started to look a little more like world markets, as global brands became increasingly recognized and the share of organized retail in the market began to grow. In one respect, India has not changed: foreign direct investment (FDI) is still not permitted in retail businesses. However, foreign companies with manufacturing bases in India are allowed to retail their products manufactured in India.

[1]Source: The McKinsey Quarterly, September 2005.

Many companies feel strongly optimistic that the reform process is now too well established to be questioned. "Policymaking is becoming more consistent," says a senior manager with a leading consumer goods company. "There is more forward movement – it's getting more difficult for politicians to put things into reverse."

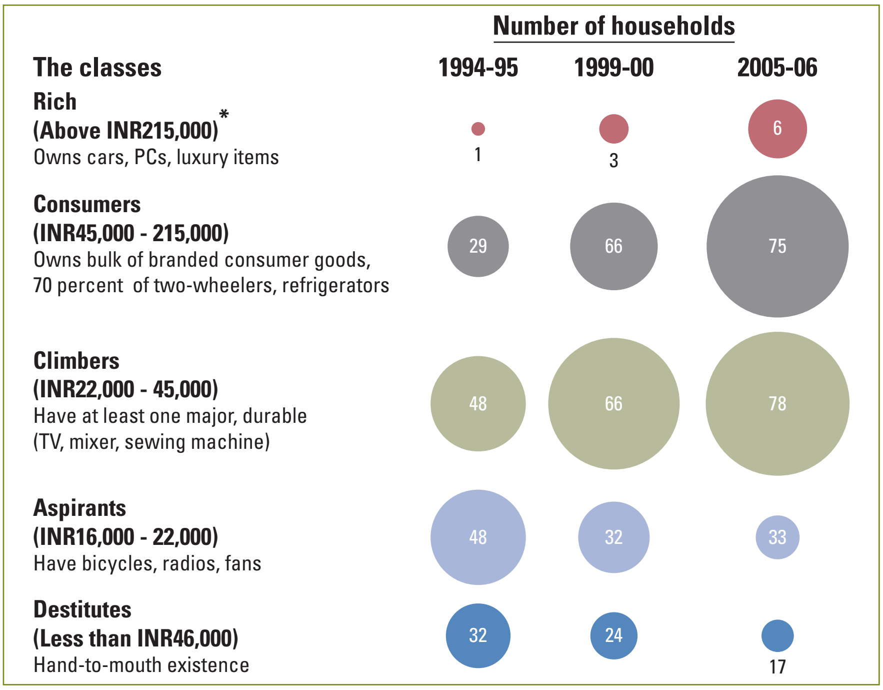
Policymaking is becoming more consistent… there is more forward movement – it's getting more difficult for politicians to put things into reverse.

Most of India's growth is in the future, not the past. The main reason for this is India's demographic advantage: India's working age population will continue to grow for the next two decades at least, unlike most emerging economies which will see their working-age populations decline as a proportion of the total. Young working populations drive personal consumption, and bring efficiency and innovation to retail markets.

"Indian consumers have evolved," says a leading watch and jewelry maker. "They expect quality to go up. And they expect prices to go down. They are interested in value."

India's consumer markets are unique. India has more people living in poverty than any other country. Its population is less urbanized than almost every other comparable economy. Literacy rates are lower than in most Asian competitors and income is less well distributed across the whole population than in most Asian competitors.

The market is also highly regional. A patchwork of cultures and languages, federal India also has a highly uneven pattern of wealth. Average state incomes in Punjab, Gujarat and Maharashtra are around five times the level in Bihar, for example. Some urban areas continue to be richer on average, while large rural areas of Bihar, Jharkand, Uttar Pradesh and Orissa are officially destitute.

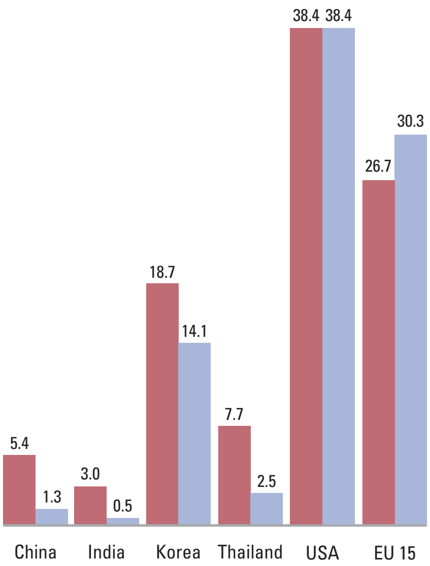


Source: *Marketing Whitebook* 2003-04 by BusinessWorld

* The average exchange rate for the first nine months of 2005 indicates that one USD is worth 43.6 Indian Rupees

If infrastructure allows you to reach the new markets at reasonable cost, then retail growth will be absolutely explosive… the issue is not the spending power of the consumer; the issue is the reach of the product.

SURVEY
Purchasing power parity



Source: IMD World Competitiveness Online *and* www.xe.com

According to recent data from India's *Marketing Whitebook* by Businessworld, India has around 208 million households. Of these only a little over six million are 'affluent' – that is, with household income in excess of INR215,000. Another 75 million households are in the category of 'well off' immediately below the affluent, earning between INR45,000 and INR215,000. In the recent past the organized consumer goods sector has concentrated almost exclusively on the 'affluent' category. The challenge for organized retailers, distributors and consumer goods manufacturers is to capture more consumers in the large category of 'well off', as well as increasing consumer goods penetration and returns in the small category of 'affluent'.

Disposable income is concentrated in urban areas and well off and affluent classes; income distribution is unequal compared to other Asian economies. Personal cars, for example, are restricted to the 'affluent'. The 'well off' can afford several consumer durables: in order of preference according to current levels of penetration, these include color televisions, refrigerators, washing machines and air-conditioners. However, in rural areas these goods are out of the range of the vast majority of the population.

Some companies also believe that there are considerable opportunities for organized retailers in the kind of rural territories that many companies have failed to address. "If infrastructure allows you to reach the new markets at reasonable cost, then retail growth will be absolutely explosive," says a vice president of a major food and beverage company. "It is not that people don't have money in the rural areas, because they do. The issue is not the spending power of the consumer; the issue is the reach of the product."

Another consumer goods producer agrees. "There are many categories of quite basic goods where penetration is extremely low, perhaps only 10 percent of households," says the company. "Now these goods could easily have a penetration of 30 percent or 40 percent: the potential for double-digit growth is pretty big."

Regulatory controls on foreign direct investment have relaxed considerably in recent years. However, while retailing currently remains closed to FDI, this is an area for ongoing debate. This means that foreign retailers and consumer goods manufacturers can only participate in the retail market through indirect access strategies, such as wholesaling, franchising or licensing, or by having a manufacturing base in India, or in businesses upstream of retailing, such as distribution services, advertising, mining and processing, oil refining, and infrastructural development, all of which permit 100 percent foreign equity participation. FDI is permitted up to specified limits in print and broadcast media, and financial services.

However, many companies expect a relaxation of the FDI bar in retailing. In January 2005 the Minister for Commerce and Industry, Kamal Nath, commented, "Many companies are selling their products in India through franchises. They want to sell their products directly. We might have a look at that." The minister added, "We are looking at FDI up to 26 percent in retail which does not disturb small retail outlets and generates economic activity and employment in other parts of the retail sector." However, during recent months there have been talks of an FDI limit being introduced in a phased manner, with some reports suggesting the starting limit at 49 percent.

Competition and pricing rules

Retailing and related businesses in India are limited by competition rules, and regulations on pricing and packaging.

India is in a transition phase during the implementation of the Competition Act of 2002, which is being phased in over three years. It replaces the earlier Monopolies and Restrictive Trade Practices Act of 1969. Mergers and acquisitions are treated liberally from the point of view of competition issues, and monopolies are not *per se* illegal.

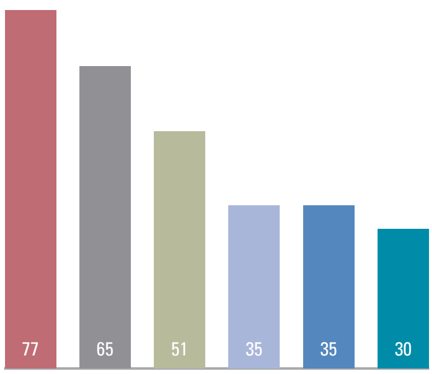
When fully implemented, the 2002 Act will forbid a number of anti-competitive practices, including price and bidding cartels and territory-sharing arrangements, and restriction of production and supply. It also bans purchase 'tie-ins' (where the purchase of one product is a condition of purchase of another), exclusive supply and distribution arrangements, exclusion of individuals or classes of person from business, and resale price maintenance. In the case of exclusive distribution, a producer may sell through a single distributor and can sue unauthorized dealers, but may not prevent the distributor from selling the products of other companies.

There are extensive controls on packaging, labeling and certification. The Bureau of Indian Standards (BIS) maintains a list of over 17,000 product standards of which only around 3,700 are in line with international norms. BIS health and safety certification marks are obligatory for over 150 items, mainly food products, some construction materials and electrical appliances. Labeling and packaging is controlled in the case of food products, pesticides and pharmaceuticals. Package size is also controlled in a range of food products.

Price controls have been progressively liberalized since 1992, but a small number of items covered by the Essential Commodities Act 1955 remain fully controlled, including coal and petroleum products. Sugar and some foods such as cereals are partly controlled; prices of kerosene and liquid petroleum gas are subsidized by central government. Most packaged goods and all imported goods must carry maximum price tags. In general, prices not controlled by central government can only be limited to a maximum price; minimum price maintenance is not permitted.

For companies taxation and infrastructure remain the leading concerns in the overall business environment in India. In interviews, companies say that indirect taxation is a key constraint in retailing, particularly the profusion of inter-state taxes that make efficient manufacturing and distribution difficult. Recently introduced VAT (which has been implemented in the majority of states) is likely to bring in a number of advantages in the consumer market area.

SURVEY
Business environment:
consumer companies cite key concerns



Taxation

Infrastructure constraints

Corruption

Delays in policy implementation

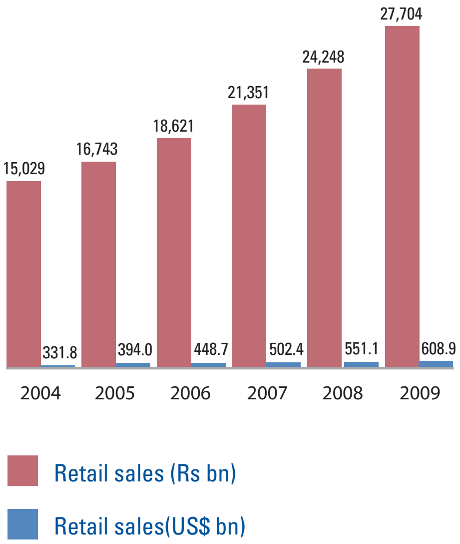
Entry laws

FDI controls

Source: KPMG Research, 2005

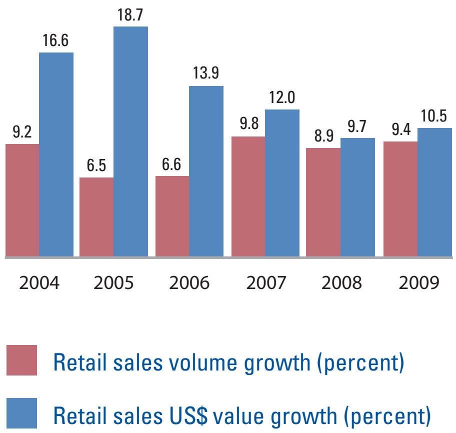
India’s retail market

SURVEY
Consumer goods forecast:
retail sales



Source: EIU Country Briefing on India, 2005

SURVEY
Consumer goods forecast:
retail sales growth



Source: EIU Country Briefing on India, 2005

Estimates of the size of the retail sector vary. The Confederation of Indian Industry (CII) estimates that the total market in 2002 was between US$180 billion and US$200 billion. ICICI, an Indian bank, used wider criteria to estimate the market at US$292 billion in 2003; the Economist Intelligence Unit (EIU) estimates the market in the same year to have totaled US$284 billion. The majority of the retail market continues to be unorganized. At present the organized sector accounts for only 2 to 4 percent of the total market, although the EIU forecasts that on current trends that will rise to between 20 and 25 percent by 2010. The level of retail sales per head remains one of the lowest in Asia.

For retailers, a critical issue is how fast and how far the consuming class will grow. This depends both on the growth of personal disposable income, and the extent to which retailers succeed in reaching lower down the income scale to reach potential consumers towards the bottom of the consumer pyramid.

This is a challenge that admits no easy solution, say companies. “There is no point in going to a destitute person and saying, here, I’ve got an aftershave lotion for you,” says a senior manager at a leading consumer product company. “You have got to find a relevant product, a needful product.”

The consumer market remains remarkably undeveloped. Consumer goods penetration is very low compared to other emerging economies, and consumer markets have the potential to grow rapidly in the coming decade.

According to a leading company that profiles household spending throughout Asia, India still has a relatively narrow middle class, reflecting a lower proportion of urban households compared to some Asian countries. It is estimated that around 70 percent of Indians live in the countryside, compared to around 60 percent of Chinese.

Consumption is moving out of the home… it's moving into lifestyle products, eating out, events, entertainment. And that is going to continue.

Indian consumers do not follow the consumption patterns seen in other Asian countries. As Indians have grown richer, they have begun to spend more on vehicles, phones and eating out in restaurants, according to recent research on consumption patterns. Indians' discretionary spending is focused outside the home; unlike other Asian consumers, they have tended not to greatly increase their spending on clothes, personal care and household goods.[1]

"Consumption is moving out of the home," says a consumer goods producer "It's moving into lifestyle products, eating out, events, entertainment. And that is going to continue."

India is also unusual in its patterns of urbanization. The population of cities has been rising in absolute terms and relative to rural population but at a rather slow rate, unlike other Asian economies. By 2001, 28 percent of Indians were living in towns, compared to 39 percent of Chinese and 83 percent of South Koreans. Some smaller Indian towns are actually shrinking as Indians congregate increasingly in larger towns, which now account for more than three-quarters of the urban population.

India's demographic advantage

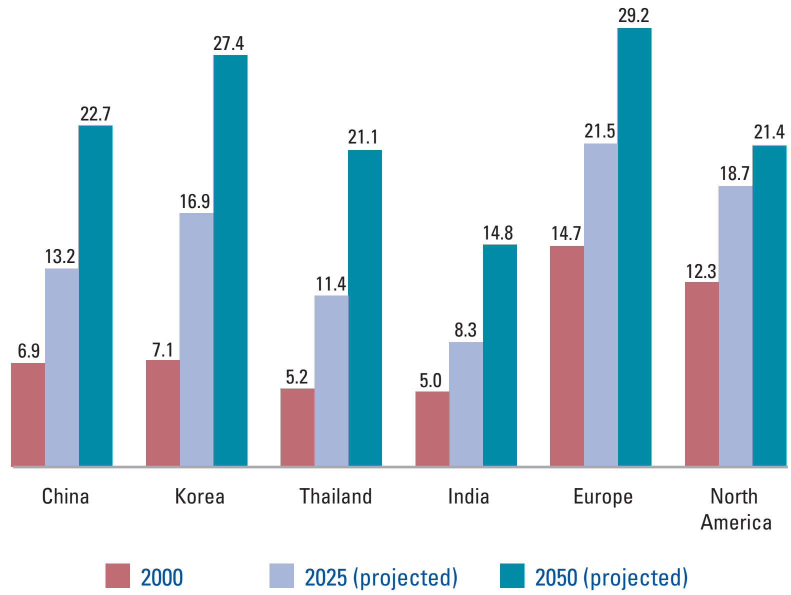
Increases in wealth, improvements in life expectancy and increased access to birth control are reducing fertility rates worldwide. The reduction is most marked in developing countries: the World Bank's population data shows that since the 1970s medical care and birth control have dramatically reduced the number of children born per couple, and dramatically increased the proportion of citizens living past retirement age.

India, however, is one of the handful of countries where the proportion of citizens of working age is forecast to fall only slowly, and the overall labor force is growing. A growing labor force both enables higher growth rates and creates an urgent political need for growth: according to the Asian Development Bank India will need to achieve around eight percent average annual growth over the next two decades to create employment for all new entrants to the workforce.

[1]Source: *India's Changing Households*, Deutsche Bank, November 2004.

India's forecast lower age dependency ratio over the next half-century means that public finances will come under less strain than in most other countries, making infrastructural investment easier and allowing the economy to continue growing well above the global trend.

Percentage of population aged 65 and older in 2000, 2025 and 2050



Source: UN *World Population Prospects: The 2000 Revision* and Taipei, China; Council for Economic Planning and Development, Official Communication, 2002

According to the National Council of Applied Economic Research (NCAER), this pro-growth demographic factor will be an important contributor to the expansion of consumer markets in India. The NCAER forecasts that the number of consumers driving growth will grow from 46 million households in 2003 to 124 million households in 2012, which will further drive increased volume in consumer markets, while increased value will be driven by the fact that consumers are predominantly young: 54 percent of Indians are under 25 years of age.[1]

For their part companies repeatedly point to the demographic outlook as the most positive factor in the long-term growth forecast for consumer markets. "Policy is positive at the moment, but demographics are a very important factor," says a senior manager at a leading consumer product company. "Who knows, tomorrow we may have a communist government, but demographics is something the government can't do anything about, so that is a guaranteed positive."

[1]Source: India market demographics report 2002, NCAER

Indian retailing is undergoing a slow but deep-rooted shift away from total reliance on countless small family-run stores towards larger, more formal retail outlets. Indian retailing is slowly but surely becoming more organized. Estimates for the total number of retail outlets vary wildly, from five million to anything over 100 million. The EIU says that India has over five million retail outlets, but that around 96 percent of them are smaller than 500 square feet. But that is beginning to change:

- Shopping malls Shopping malls are becoming increasingly common in large cities, and announced development plans project at least 150 new shopping malls by 2008. Even allowing for exaggeration in the number of projected new malls, it is likely that over the next three years consumers will see a great increase in the number of formal retail spaces where recognized brands and consumer credit will be available.

- Department stores There are around 100 department stores in India. The segment is growing much faster than overall retail – the number of stores has been growing by an annual 24 percent, and sales have grown at around 34 percent during 1999-2002.

- Supermarkets and hypermarkets Supermarkets have been taking an increasing share of general food and grocery trade over the last two decades; a recent trend is the introduction of very large discount-oriented stores, known in India as hypermarkets. These are typically of 50,000 square feet or greater, stocking around 20,000 products.

Specialized retailers are also developing rapidly. These include medium-to-large format retailers in segments like consumer durables and white goods, books, music, lifestyle goods, household furnishings, furniture, DIY, and healthcare and beauty. Specialized consumer durables retailing is more developed in the southern states.

Manufacturers are increasingly developing retail outlets. The largest Indian PC maker for example, has over 200 retail outlets. In consumer white goods, which are typically sold in large department stores, foreign manufacturers are increasingly taking market share from Indian producers.

Formats for entry in India

Direct participation in Indian retail businesses is still not permitted under India's regime of FDI controls, although Minister for Commerce and Industry Kamal Nath has hinted that the total ban on retail FDI might soon become an equity participation cap, possibly of 49 percent. Till the time a ban is lifted from the FDI, quite a few international retailers in India have adopted different strategies for operating in India. These strategies and models include the following:

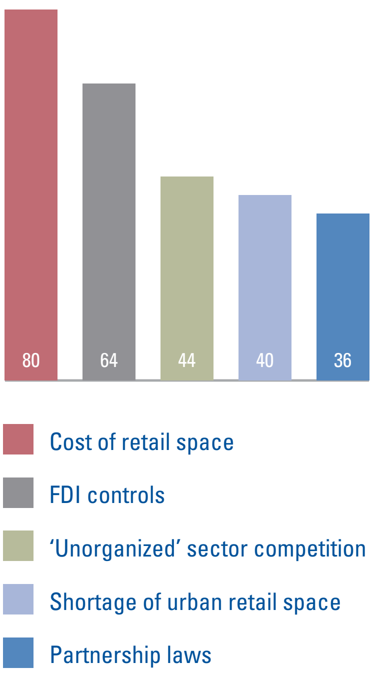
Franchise agreements Franchising is the most widely used entry route by international retailers. Fast food retailers like Domino's have entered India through the master franchise route, while Pizza Hut has entered India through multiple regional franchisees.

Cash & carry wholesale trading 100 percent FDI is allowed in wholesale trading, which involves building of a large distribution infrastructure to assist local manufacturers. The business model is built such that the wholesaler deals only with smaller retailers and not consumers. Metro AG, Germany was one of the first significant global players to enter India through this route. Shoprite of South Africa has effectively used a combination of cash and carry wholesale trading and franchising to set up their first hypermarket in the suburbs of Mumbai.

Strategic licensing agreements This route involves the foreign company entering into a licensing agreement with a domestic retailer. Mango, the Spanish apparel brand has entered India through this route with an agreement with Major Brands, a departmental store in Mumbai.

Companies say they have short-term concerns over the cost of retail space, although extensive mall-building plans may ease costs in the medium term. The ban on foreign direct investment in most forms of retailing is also considered to be a negative. In interview domestic retailers say that despite the threat of increased competition, they would expect the arrival of experienced global retailing groups to improve the quality of retail distribution and marketing in India.

SURVEY
Retail environment:
consumer companies cite key concerns



Source: KPMG Research, May 2005

The distribution challenge

Distribution continues to improve, but still remains a major inefficiency. Poor quality of infrastructure coupled with the poor quality of the distribution sector results in logistics costs which are very high as a proportion of GDP, and inventories which have to be maintained at a very high level.

India is the world's seventh-largest country in terms of area, with a majority of the population living in rural areas. Reaching this fragmented and dispersed market significantly increases the complexity of distribution for companies in India. But according to some companies, addressing potential consumers is perfectly feasible. "Even with the lack of infrastructure there is actually a very well developed distribution system in India, right down to the three-wheelers that go into villages without any roads," according to a leading FMCG company, "But it is a complex system, and you have to understand that complexity."

A big distribution problem is the lack of cold storage chains… private logistics companies should be coming in and offering refrigerated transport, but they are not.

Transport is a key constraint. The state highway network is limited, although a major improvement is in the pipeline with the expected completion in 2007 of the 'Golden Quadrilateral' project of highways linking Delhi, Kolkata, Chennai and Mumbai. Commercial freight transport is moving away consistently from rail and on to the roads. India's rail transport system is deteriorating, and the proportions of many categories of goods transported by rail have halved over the last 15 years, according to the World Bank's most recent investment climate report.

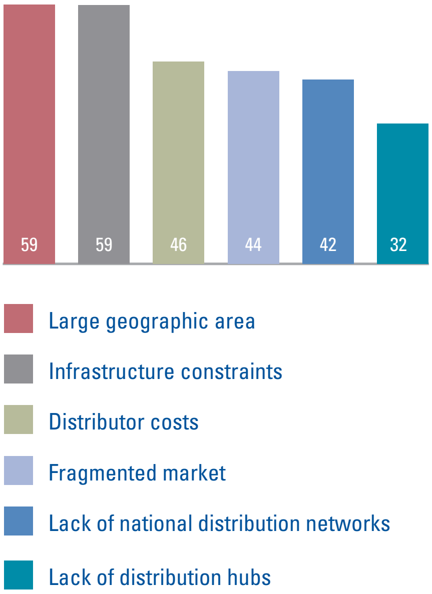
The Centre for Monitoring the Indian Economy (CMIE), an independent economic research company based in Mumbai, has calculated that total logistics costs in India amount to between 10 percent and 12 percent of GDP. The CMIE estimates that inventories in the entire economy amount to over US$22 billion, equivalent to around 22 percent of total annual sales in the economy.[1]

In the retail sector, factors contributing to high inventory are the fragmented retail market, and the high proportion of retail business taking place in the 'unorganized' sector – often informal businesses in rural areas that may be many miles from paved roads – which leads to much higher levels of 'safety stocks' than in organized retailing. The state sales tax regime encourages local stock points in each state, say companies. The transport and warehousing industry is fragmented and lacks scale – the average load carried by trucks in India is low by global standards, at around seven tons. Third party logistics is also undeveloped, and most businesses manage distribution and logistics themselves.

"A big distribution problem is the lack of cold storage chains," comments an industrialist. "Private logistics companies should be coming in and offering refrigerated transport, but they are not. So if you want to sell ice cream, say, you have to have your own vehicle fleet, and that is not necessarily the most cost effective way to go to market."

[1]Source: www.dqindia.com

SURVEY
Consumer companies cite key distribution concerns

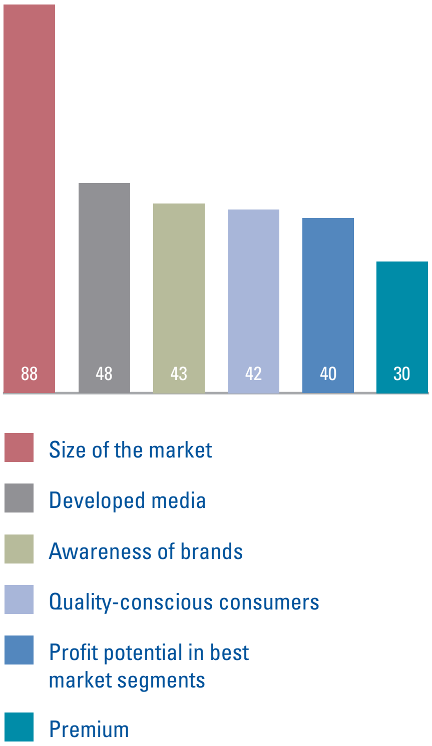


Source: KPMG Research, May 2005

Companies say that the large geographical area of India together with its relatively weak infrastructure are the most important constraints on distribution. In an interview, one retailer says, "India is not like one country, it is like 25 different countries." The quality of third party distribution services is also a concern, says a senior executive of a logistics company. "The distribution problem in India is nothing to do with the state of the road surface, it is to do with the lack of distribution capacity." The lack of a developed hub-and-spoke distribution structure is also of concern: most companies attribute this to taxation barriers between states that act as barriers to efficient regional distribution.

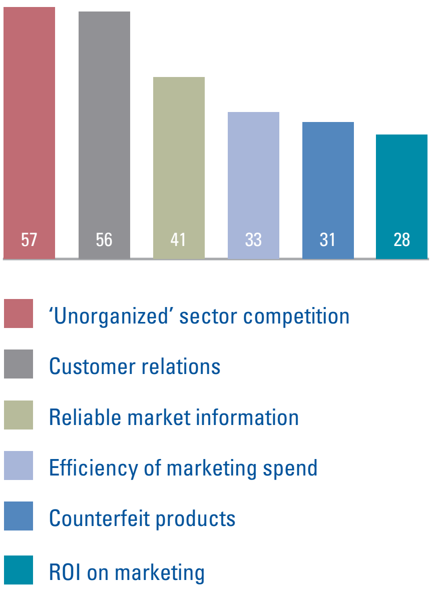
Advertising and marketing

SURVEY
What factors make India conducive to cost-effective marketing?



Source: KPMG Research, May 2005

SURVEY
Consumer companies cite key marketing concerns



Source: KPMG Research, May 2005

Indian consumers are becoming increasingly sophisticated and knowledgeable about products; media channels that allow companies to communicate with consumers are growing in diversity and reach. Consumers are getting richer, leading to competition in the market-place for consumer products. The result is that consumer companies are increasingly concerned with marketing issues, as they seek to differentiate their products and communicate their values to potential customers.

In our survey consumer companies were asked to rate India's attractiveness in terms of the extent to which the environment is conducive to cost-effective marketing. The most attractive factor, say companies, is the sheer size of the Indian market. They also consider that advertising is developed – most global advertising companies have established operations in India. Companies say the growth in media channels brought about by economic liberalization has made people increasingly aware of brand values. A smaller number of companies believe that India offers significant opportunities on selective brands, which provide higher margins.

Companies were also asked about the key challenges in marketing. They considered that the fact that retailing is still predominantly an unorganized market is the leading issue, and that customer retention is also a challenge (loyalty schemes are becoming increasingly popular). Reliable market information is considered an issue, but the threat from counterfeiting comes much lower on the list of priorities, as does the return on marketing costs: most companies believe that marketing budgets are well spent.

"Counterfeiting is very damaging but it is a global phenomenon, not an Indian phenomenon," believes a leading sportswear company. "The real problem with it is that it stops the brand being read in the way that it should be. It is definitely an area where we need more government help to deal with the problem."

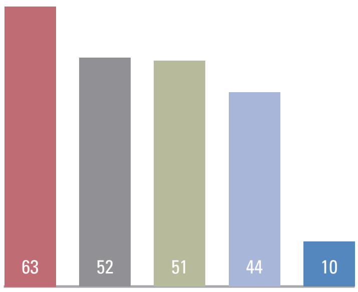
Some companies believe that an important challenge for large global companies is to gain an understanding of Indian consumers. "Multinational companies tend to have pre-conceived ideas about Indian consumers," says a senior manager at a consumer goods company. "They won't adapt products, they won't adapt packaging. I worked for one of the biggest consumer goods MNCs and they took years to accept that Indian consumers won't buy exactly the same products as the rest of the world."

Companies also say that innovative marketing can be the solution to tackling the fragmentation and relative poverty of much of the Indian market. A senior manager at a consumer goods company points to the recent success of very small packages or sachets of personal care products, "The sachet phenomenon is an example of reaching to the bottom of the pyramid. It was a recognition that a lot of people in India are just not willing to buy a whole bottle of shampoo. That doesn't mean they won't buy shampoo."

Counterfeiting is very damaging but it is a global phenomenon, not an Indian phenomenon.

Companies say that foreign brands remain very powerful in India. Of the companies surveyed, 98 percent say that foreign brands can command a premium, although only 26 percent think that the majority of foreign brands come into that category, 63 percent believe the premium is restricted to a few brands, and 9 percent think it is restricted to very few. Companies say that foreign brand power is most visible in clothing and personal care products, but that increasingly brands have to be associated with value. Says one of the leading watch and jewelry makers, "Foreign brands used to command a premium, I suspect that increasingly, what the consumer wants to know is not 'Am I getting a foreign brand?' but 'Am I getting a good deal?'"

SURVEY
Consumer companies cite key advertising challenges



Identifying insights

Media clutter

Integration of multimedia campaigns

Using emerging media

Source: KPMG Research, May 2005

Advertising is of increasing concern to companies, as channels multiply and product offerings become more sophisticated. "Advertising is becoming a bigger and bigger part of the marketing mix," says a leading watch and jewelry maker. "Because markets are growing but competition is increasing, you absolutely have to advertise." Companies report that the biggest challenge is to identify consumer insights to make relevant advertisements. They are also concerned about the profusion of media channels – 'media clutter' – and the increasing number of brands competing for the same space. Consumer product companies also feel that a big challenge is measurement of the impact of advertising and promotional activities. Says one consumer products company, "The biggest issue in marketing is media fragmentation. Years ago you could run an ad on TV and know 80 percent of TV owners would see it. Now we have so many channels that you don't know how to focus."

Some companies express concern that advertising messages can only travel limited distances in the Indian market. "A lot of companies are not able to reach further down, towards the bottom of the 'consumer pyramid'," says a senior manager at a consumer products company. "Price is one issue. But there is also communication. How do you talk to someone who is illiterate, who doesn't have access to a TV or a radio?" And another watch and jewelry maker believes that increasingly companies will have to seek multiple advertising channels: "Mass media is becoming less and less effective," the company says. "You can pour money into TV these days and see absolutely no effect on your sales."

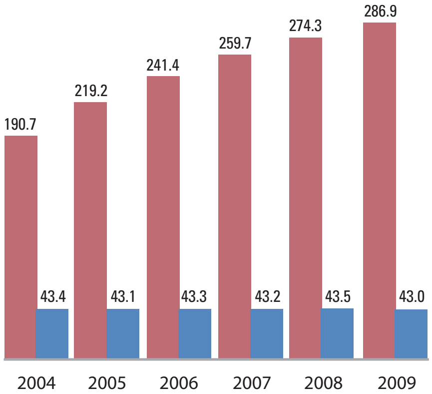
Food, beverage and consumer goods

The greatest organized retail growth opportunities by size of segment are in food and beverage. While the organized sector accounts for only 2-4 percent of the total retail market at present (although the proportion is growing fast), only around 0.5 percent of all food retailing takes place in large shops and supermarkets, according to the EIU, which forecasts that food and beverage retailing will grow at 9.2 percent over the next five years against a total GDP growth rate of around 7 percent.

India is one of the world's largest food producers, producing around one ton of food for every single inhabitant. It is the world's biggest producer of livestock, the biggest producer of milk, and the second largest producer of fruit and vegetables.

India is also one of the world's major food and drinks markets, reflecting the large population rather than high spending levels. Estimates of the size of the market vary as the true size of the informal market is difficult to measure: the EIU estimates that combined food beverages and tobacco spending totaled US$190 billion in 2004 (compared to around US$240 billion in China, which is of similar population size); a study by the Federation of Indian Chambers of Commerce and Industry (FICCI) concluded that the food market alone was around US$70 billion in 2004, although that is most likely an underestimate.[1] The Indian Department of Commerce forecasts that investment in the segment will exceed US$4.8 billion in the financial year ending in 2005.[2]

SURVEY
Food and drinks forecast: consumer expenditure



Food, beverages and tobacco (US$ bn)

Food, beverages and tobacco (percent of household spending)

Source: EIU Country Briefing on India, 2005

The EIU forecasts that spending growth will rise, from around 6 percent in 2000-2004, to around 9 percent in 2005-2009. The proportion of household spending accounted for by food is falling, from around 54 percent in 1995 to a forecast 43 percent by 2009: this pattern is in line with the trend in most emerging economies. The forecast growth in personal disposable incomes will allow food and beverage spending to rise faster than average GDP growth, while still falling marginally as a proportion of household spending.[2]

Most food consumed in India is domestically produced, and spending is influenced by climatic conditions: poor monsoons reduce supply and push up prices, reducing discretionary spending on luxury food items. However, very sharp price rises are unlikely, as the federal and state governments maintain substantial buffer stocks of essential foods which are used to forestall significant shortages.

The main growth opportunity in the segment is in processed foods: Indians consume less processed and prepared food and drinks than most other nations, and only around 2 percent of India's agricultural output is processed (although even at that low level food processing is the country's fifth biggest industry, representing 4.3 percent of GDP). Most processed food is exported: however, rapid growth in the processed food segment of domestic consumer markets is

[1]Source: www.ficci.com

[2]Source: EIU Briefing on India, 2005

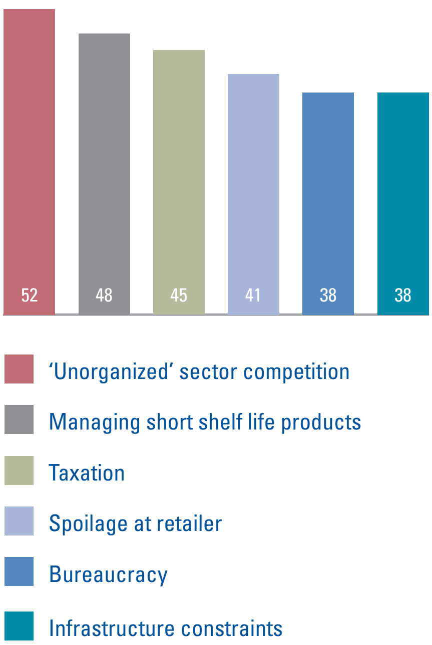
already apparent, evidenced by the rapid expansion of branded food outlet and café chains. "Indian consumers are used to fresh produce," says a representative from a leading industry body. "To get them interested in new packaged products you have to have product innovation and packaging innovation. And that has really started to happen in the last 10 years."

To get them interested in new packaged products you have to have product innovation and packaging innovation.

Another consumer products manufacturer adds "Indians respond to product innovation. Look at the way Café Coffee Day marketed coffee – there's nothing new about coffee, but drinking coffee in a store was new to Indians."

Meat consumption is growing very slowly (at an average annual rate of less than 2 percent over the last five years), with the market for chilled and frozen meat very small. Beef is considered to be a downmarket product (the slaughter of cows is banned in all but two states for religious reasons). Poultry consumption is growing much faster. Fish consumption is also low compared to other emerging economies, at 4.8 kg per head, and much of India's marine production is exported. The EIU forecasts that rising incomes will increase domestic consumption over the next five years quite significantly, to 5.8 kg per head. Dairy consumption has been virtually stagnant over the last five years, and consumption per head is below the World Health Organization's recommended minimum of 283 grams per day. Fruit and vegetables are largely consumed fresh, with only a very small proportion of output processed. The EIU forecasts that annual growth in consumption will be around 4 percent to 2009. The rise in coffee drinking is part of the transition to more branded consumption in India, and is led by the growth of branded coffee café chains such as Barista, Café Coffee Day and Qwiky's. Foreign chains are also beginning to participate in the retail market through franchise agreements. The EIU forecasts annual consumption growth of 9.5 percent during 2005-2009. Soft drink consumption is expected to grow faster, at around 12 percent a year, mainly due to increasing sales of fruit drinks and bottled waters. India is also an important market for alcoholic drinks, although beer consumption is relatively low (India has less than 0.5 percent of the per capita consumption of the UK, for example), and regionally concentrated (Maharashtra, Andrha Pradesh and Karnataka account for nearly 50 percent of the total market). The market for wine spirits and liqueurs is larger although growth is low: the segment had sales of around US$48 billion in 2003. Recent tariff reductions on foreign branded spirits is expected to increase consumption by value.

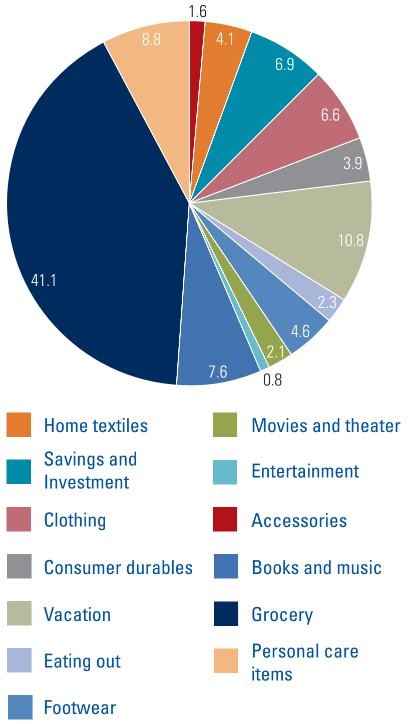
SURVEY
Consumer companies cite key food and beverage concerns



Source: KPMG Research, May 2005

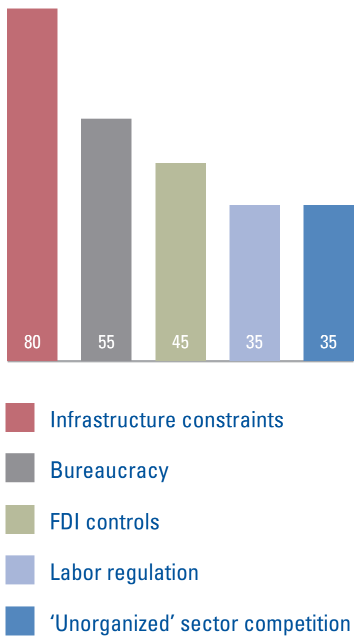
Regulatory change will spur growth in food and beverage production for consumer markets. Under the Essential Commodities Act, producers were formerly prevented from transporting a range of specified products across state borders. This led to increased manufacturing and distribution costs as companies needed multiple manufacturing and distribution centers to stay within the Act. These provisions have now been repealed, allowing manufacturing and distribution to be consolidated at single locations.

SURVEY
The consumer's shopping basket in 2003



Source: BW Marketing Whitebook 2005

SURVEY
Consumer companies cite key FMCG concerns



Source: KPMG Research, May 2005

In general companies say that they expect the 'unorganized' or informal retail sector to remain strong in the face of increased competition from organized retailing corporations: this is most markedly so in the food and beverages segment. Managing short shelf life products is also a leading concern, partly because much of India does not have developed cold-chain distribution.

Fast moving consumer goods (FMCG)

Some companies prefer to categorize food and beverages retailing as part of the fast-moving consumer goods (FMCG) segment, which also comprises household and personal care products, confectionary and tobacco. Overall this segment accounts for around 80 percent of consumer spending in India.

As with many other retail segments, companies say the main driving forces in the FMCG segment are rising disposable income together with changing lifestyle patterns in India. Low-priced products constitute the majority of sales volume, and lower income and lower middle-income consumers accounting for over 60 percent of sales.

Rural markets account for around 56 percent of total FMCG demand, although some companies believe that much more can be done by the organized sector to tap rural demand. "Road infrastructure is improving and communications infrastructure is improving," says a vice president of a leading FMCG company; "There is no reason why as many as 300 million new consumers cannot be brought into the 'consumer basket'. Just by increasing the geographical reach, there will be enormous growth in the FCMG sector."

After four years of growth of between 1 and 1.5 percent, the segment saw revival in 2004, driven in part by a surge in retail innovation. Retailers introduced price cuts, and launched new packaging sizes together with discounts and promotional offers.

By a large margin companies identify poor infrastructure as the key constraint in the FMCG segment, as in other sectors of the economy. Bureaucratic control and the lack of a 'single window' administrative procedure to approve new business investments are also considered constraints, although in interview many companies concede that Indian's bureaucratic handling of business issues is improving quite fast. The FMCG segment is also the area of retailing where companies are most likely to cite FDI controls on retailing investment as a constraint to growth.

Gemstones and jewelry

India has a special claim to prominence in the gemstones and jewelry markets: it is the world's leading producer of finished jewelry and polished precious stones. Gemstones and jewelry represents the most significant specialist segment of Indian retailing, accounting for a high proportion of total retail spend, and also representing a growing global retailing operation as Indian retail chains begin to expand into high-value markets in the Middle East, Europe and the U.S.

An industry like gems and jewelry needs to work harder on standards and certification, to build customer confidence.

India is not only the largest importer and consumer of gold, but also a major exporter of gems and jewelry (Indian exports are currently worth around US$15.7 billion annually).[1] India now accounts for 55 percent of global net exports of cut and polished diamonds in value terms, and is the world leader in the processing of rough diamonds: 11 out of 12 stones set in jewelry worldwide are processed in India.

Gold dominates the jewelry market, although platinum and diamond products have been gaining market share at the very top end of the market. Gold jewelry is estimated to account for around 80 percent of the Indian market.

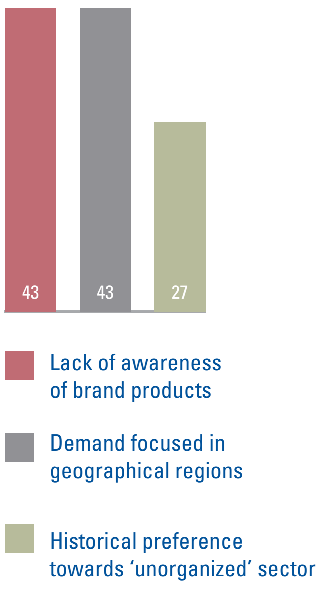
According to India's Gems and Jewelry Export Promotion Council, the total jewelry market in India is around US$13 billion, of which diamond jewelry makes up about 20 percent. The segment is dominated by very small family-owned retailers, and the total size of the market is difficult to measure. Indian households have traditionally relied on a family jeweler to provide quality assurance. Consumer brand awareness is low. Regional festivals and customs drive demand: most purchases take place at festival periods and to celebrate family rituals such as marriages and births.

"Indian consumers are very concerned about reliability; the issue of trust," says a senior executive at a diamond company. "An industry like gems and jewelry needs to work harder on standards and certification, to build customer confidence."

However, the market is evolving, as are all Indian markets. More families are forming, and double-income households are growing. Organized jewelry retailers are increasingly offering brand solutions to the demand for quality and value, as consumers move away from traditional family retailers.

[1]Source: Gems and Jewelry Export Promotion Council

SURVEY
Consumer companies cite key gems and jewelry concerns



Source: KPMG Research, May 2005

Branding is a key issue for organized retail, say jewelry companies. Unorganized family-oriented retailers dominate this sector, and many buyers prefer to rely on known local jewelers than to buy in formal shops. Companies say that brand development will be the key to growth for organized retailers, but expect this part of the segment to grow rapidly as Indian buyers become more mobile, more independent and younger.

In the future, it is likely that fewer and fewer diamonds will be exported, as Indian companies now prefer converting them into jewelry, where the revenue earning potential is much greater. On the whole, the future for jewelry export looks bright. The Gems and Jewelry Council is expecting exports to increase to US$17 billion by the year 2007. This is definitely the silver lining that all the exporters are looking forward to – and if possible, they are hoping to over-achieve this target.

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