14 September 2012

EY Regulatory Alert

Retail sector – Foreign Direct Investment Policy

Foreword

On 14 September 2012, the Cabinet Committee on Economic Affairs ('the Cabinet') made a landmark decision of permitting up to 51% Foreign Direct Investment ('FDI') in Multi-Brand Retail ('MBR') trading in India. The Cabinet has also approved the amendments to the existing policy on FDI in Single-Brand product Retail ('SBR') trading and thus liberalized the conditions relating to brand ownership and mandatory sourcing requirements.

This alert summarizes the press releases on the above decisions taken by the Cabinet on key conditions prescribed for FDI up to 51% in MBR trading and amendments to the conditions for SBR trading.

These decisions would become effective post issuance of press notes by the Department of Industrial Policy and Promotion, Ministry of Commerce and will form part of the Consolidated FDI Policy (Circular 1 of 2012).

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Background

FDI in retail trading in India has been progressively liberalized over the last few years. The above FDI liberalization is a historic step given the long journey of opening up of retail sector in India.

The backdrop in relation to which FDI policy announcement has been made is summarized below.

MBR trading

In the month of November, 2011, the Cabinet had approved the proposal for 51% FDI in MBR trading. However, the implementation of the proposal was deferred vide an announcement made on 7 December 2011.

Subsequently, post discussions with various stake holders, the proposal to permit FDI up to 51% in MBR trading has now been approved along with certain safeguards and subject to fulfillment of prescribed conditions (including the earlier conditions stated in the earlier press release issued in the month of November 2011).

SBR trading

In 2006, 51% FDI in SBR was first permitted with prior Government approval and subject to fulfillment of following conditions – (i) The products to be sold should only be of a single brand; (ii) Products should be sold under the same brand internationally; and (iii) SBR trading only covers products that are branded during manufacturing. Further, with effect from 1 October 2011 an additional condition was introduced stating that (iv) the foreign investor in a SBR trading entity should be the owner of the brand.

Later vide press note dated 10 January 2012, FDI limit in SBR trading was increased to 100% under the Government approval route, subject to fulfillment of an additional condition for FDI beyond 51%, relating to mandatory sourcing of “30% of products sold” from Indian small Industries/ village and cottage industries, artisans and craftsmen.

The above mentioned conditions relating to brand ownership and mandatory sourcing from Indian small industries have now been relaxed.

Announcements - Allowing up to 51% FDI in MBR trading

FDI in MBR trading up to maximum of 51% has now been permitted in MBR trading with a prior Government approval, subject to fulfillment of following additional/ amended conditions:

(i) State approvals

Retail sales outlets may be set up in those states which have agreed or agree in future to allow FDI in MBR trading under this policy. The establishment of the retail sales outlets will be in compliance of applicable State laws/ regulations, such as the Shops and Establishments Act etc.

Thus, the policy provides that it would be the prerogative of the state Governments to decide whether and where a multi-brand retailer, with FDI is permitted to establish its sales outlets within the state. Therefore, implementation of the policy is not a mandatory requirement for all states.

(ii) Cities where retail sales outlets can be set-up

Retail sales outlets may be set up only in cities with a population of more than 10 lakh (ie, 1 million) as per 2011 census[2] and may also cover an area of 10 kms around the municipal/urban agglomeration limits of such cities.

In States and Union Territories not having cities with population of more than 1 million as per 2011 census, retail sales outlets may be set up in cities of their choice preferably the largest city and may also cover an area of 10 kms around the municipal/urban agglomeration limits of such cities; if such states are desirous of implementing the policy for permitting FDI in MBR trading.

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[2] *As per 2011 Census, 53 cities have a population of more than 1 million.*

It has also been prescribed that retail locations will be restricted to conforming areas as per the Master/Zonal Plans of the concerned cities and provision will be made for requisite facilities such as transport connectivity and parking.

(iii) Mandatory investment in 'back-end infrastructure'

At least 50% of total FDI brought in shall be invested in 'backend infrastructure' within three years of the induction of FDI.

'Back-end infrastructure' will include capital expenditure on all activities, excluding that on front-end units. For instance, back-end infrastructure will include investment made towards processing, manufacturing, distribution, design improvement, quality control, packaging, logistics, storage, ware-house, agriculture market produce infrastructure etc. However, expenditure on land cost and rentals, if any, will not be counted for purposes of backend infrastructure.

The press release issued by the Cabinet also states that the other conditions stated in the earlier press release dated 25 November 2011 would continue to apply. In view of this, following conditions/ safeguards would also have to be complied with:

(iv) Minimum investment

Minimum amount to be brought in as FDI by the foreign investor would be USD 100 million.

(v) Mandatory procurement requirements

At least 30% of the procurement of manufactured/ processed products has to be sourced from Indian 'small industries'.

'Small industries' have been defined as industries which have a total investment in plant & machinery not exceeding USD 1 million at the time of installation (without providing for depreciation). Further, if at any point in time, this valuation is exceeded, the industry shall not qualify as a 'small industry' for this purpose.

(vi) Fresh agricultural produce

Fresh agricultural produce including fruits, vegetables, flowers, grains, pulses, fresh poultry fishery and meat products may be unbranded.

(vii) First right to procurement

In respect of agricultural products, Government will have the first right to procurement.

(viii) Self-certification by the company

Self-certification by the MBR trading company to ensure compliance of the conditions as above, which could be cross-checked as and when required and thus accounts duly certified by statutory auditors should be maintained.

Separately, in response to a demand articulated by traders' associations during the course of consultations conducted by the Government with various stakeholders, it has been proposed to constitute a high level group under the Minister of Consumer Affairs. The purpose of this group would be to examine various issues concerning internal trade; make recommendations to the Government for internal trade reforms and to ensure distributional efficiencies and also to ensure that benefits from trade are available to all sections of society.

Announcements - Relaxation of SBR conditions

Following amendments have been approved to relax the existing conditions relating to FDI in SBR trading

(i) Brand ownership

One of the conditions for investment in SBR trading stipulated that the foreign investor should be the owner of the brand. However, globally different models are adopted by retailers whereby the entity owing the brand and the investor entity are separate, even though they are a part of the same group. Resultantly, such business models could not be in consonance with the condition that the foreign investor should be the brand owner.

It has been recognized that this condition relating to brand ownership posed challenges before foreign SBR trading companies wanting to invest into India and accordingly following amendments have been approved

- Only one non-resident entity, whether owner of the brand or otherwise, shall be permitted to undertake SBR trading for the specific brand, through a legally tenable agreement, with the brand owner for the specific brand for which approval is being sought.

- The onus for ensuring compliance with this condition shall rest with the Indian entity carrying out SBR trading in India.

- The investing entity shall provide evidence to this effect at the time of seeking approval, including a copy of the licensing/ franchise/sub-licence agreement, specifically indicating compliance with the above condition.

(ii) Mandatory sourcing

The mandatory 30% sourcing requirement from MSMEs, village and cottage industries, artisans and craftsmen for FDI in SBR trading beyond 51% posed several challenges. This condition was difficult to comply with especially in the case of very specialized/high technology items, niche products having specialized requirements of quality and precision which are difficult to source from MSMEs, village and cottage industries, artisans and craftsmen.

Small industries' have been defined as industries which have a total investment in plant & machinery not exceeding USD 1 million at the time of installation (without providing for depreciation). Further, if at any point in time, this valuation is exceeded, the industry shall not qualify as a 'small industry' for this purpose

Since this condition was acting as a deterrent, following amendments to the sourcing condition have been approved:

- In respect of proposals involving FDI beyond 51%, sourcing of 30%, of the value of goods "purchased", will be done from India, preferably from MSMEs, village and cottage industries, artisans and craftsmen, in all sectors, where it is feasible.

- The quantum of domestic sourcing will be self-certified by the company, to be subsequently checked, by statutory auditors, from the duly certified accounts which the company will be required to maintain.

- For the purpose of ascertaining the sourcing requirement, the relevant entity would be the Indian company which is the recipient of FDI for the purpose of carrying out SBR trading.

Other conditions for SBR which continue to apply are as follows:

(iii) The products to be sold should only be of a single brand;

(iv) Products should be sold under the same brand internationally;

(v) SBR trading only covers products that are branded during manufacturing.

Comments

This is a landmark development for the retail sector in India, and is likely to present opportunities for both global as well as Indian retailers.

Foreign MBR and cash & carry players could explore MBR joint ventures with Indian partners. Foreign SBR players could explore joint ventures with Indian partners, or explore up to 100% owned SBR business.

Indian MBR players could explore strategic partnerships with foreign retailers either by way of selling part stakes or by issuing further capital. Indian joint venture partners in existing SBR businesses could explore diluting their stake in the SBR venture or consider sell-offs.

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