# Agribusiness & Food Industry in India

*Impact of FDI in Retail*

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# contents



## CONTACT US


**Varun Arora**
**Senior Consultant, India**
**Email: varun.arora@ipsos.com**

**Suheil Murgai**
**Associate Director, India**
**Email: suheil.murgai@ipsos.com**


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# Foreign investment in India's agri-business and food processing industry

India's retail industry was revolutionised by government reforms last September which allowed foreign firms for the first time to own a controlling stake in retail operations. Previously they had been confined to the wholesale market. The decision was contentious and remains a hotly contested issue today in both political and economic spheres.

Foreign investors and pro-reform Indian companies, however, hailed the move as a groundbreaking development that would stimulate foreign investment in the industry and usher in new levels of international expertise in areas ranging from back-end infrastructure and supply chain management to retail operations and customer segmentation. These developments should enhance the efficiency and competitiveness of India's retail sector with wide ranging benefits for consumers and the economy.

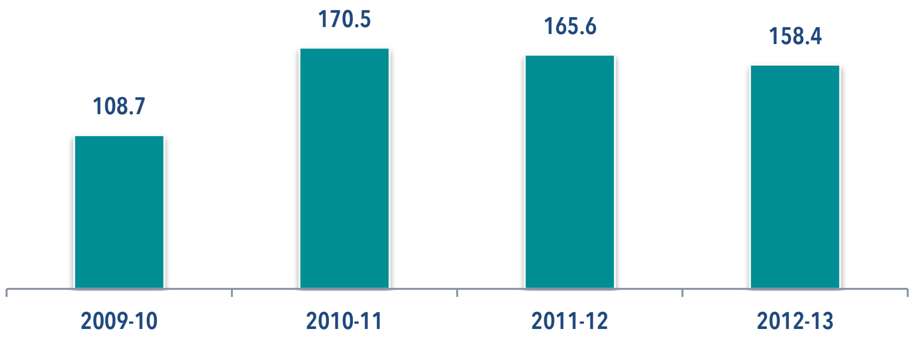
# India's agricultural sector

Agriculture is one of India's largest sectors accounting for about 14 per cent of the economy and employing more than 60 per cent of the country's workforce, directly and indirectly. It is a significant driver of socio-economic development. However, its contributions have declined over recent years due to sluggish growth and the changing face of Indian society. The government has implemented numerous stimulus schemes for the sector with minimal effect. Budgets at the Department of Agriculture and Cooperatives have also waned over the past few years, a trend likely to signal further lacklustre performance for the industry.

Inefficiency and dispersion within the farming sector are seen as key factors hampering the industry's development. Most farms are unorganised small-scale holdings owned by families or small companies and cooperatives. The most recent Agricultural Census 2010-11 found smallholdings – defined as farms with less than 2 hectares of land – accounted for 85 per cent of total farms in the country, while only constituting 44 per cent of cultivated land.

Such wide dispersion seriously weakens the productivity and bargaining power of smaller farmers. Even when they yield bumper harvests, smaller farms fall victim to oversupply and are forced to sell crops at lower prices. A lack of infrastructure and storage facilities only amplifies these problems, leaving them at the mercy of middlemen, brokers and larger companies with silos. A recent in a western state revealed that 28 per cent of paddy output was sold at cost and 45 per cent sold with a 5-10 per cent margin. The highest margin recorded was just 15 per cent.

Figure 1: Agricultural spending, 2009-13 (rupees, billions)




Source: Ministry of Agriculture

# Agri-food sector

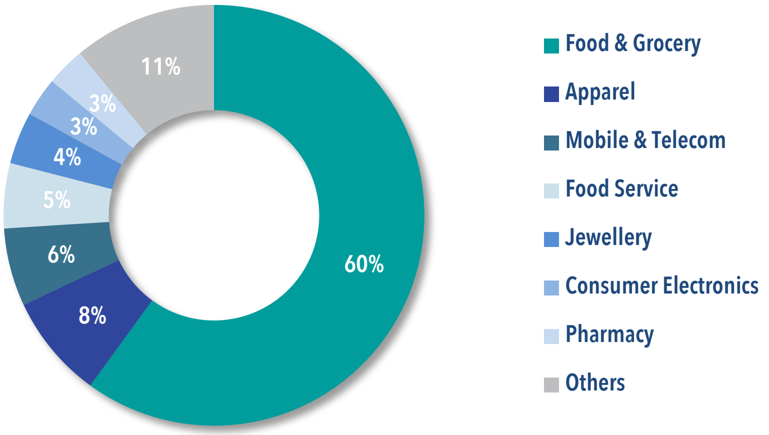
This sector contributes a large portion of the Indian consumer's basket and comprises two segments:

1. Fresh produce (fruit and vegetables, grains, pulses, rice, etc)
2. Processed foods

Any increases in efficiency at the production and distribution levels should yield significantly higher margins while still delivering affordable products to consumers.

Currently, incumbent organised retailers have focused on improving supply chain efficiencies for fresh fruit and vegetables but have left processed foods relatively untouched. Fresh food has attracted a lot of investment due to the commodity's perishability, with much focus on back-end infrastructure such as cold storage facilities.

Figure 2: Share of the consumer basket by sector




Source: India Retail Report 2013

# Fresh produce, grains and pulses

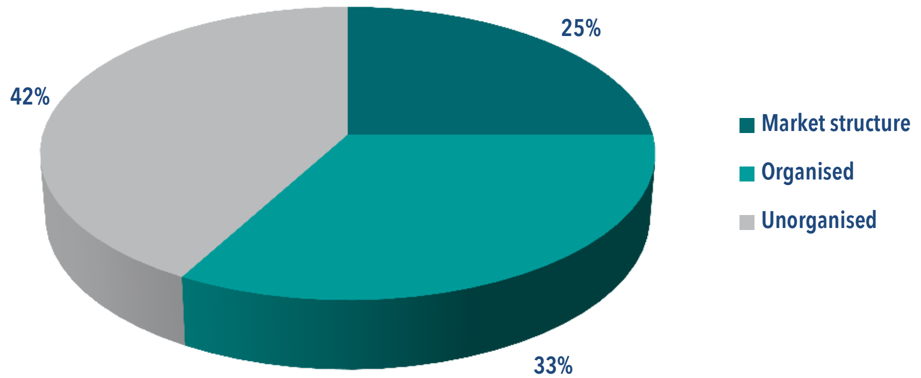
This sector comprises products which are procured and sold in raw form with processing restricted to grading, sorting and similar activities. Major participants in the fruit and vegetables segment are farmers, brokers, wholesalers and retailers. Many cold storage chains recently started operating on a large scale and in some cases replaced wholesalers.

State governments have, under the Agriculture Produce Marketing Committees Act (APMCA), established dedicated grain markets where farmers are required to sell their produce. Private companies are also prevented from buying directly from farmers. This has only served to strengthen the role of brokers/middlemen who act as dealmakers and rather than adding value simply increase product costs by 4-5 per cent. The present supply chain is plagued with inefficiencies due to these intermediaries. As a result, domestic organised retailers have started purchasing directly from farmers through contract farming in states which have relaxed APMCA restrictions.

# Processed food segment

As an important part of the agri-food supply chain this segment's market share is growing steadily when compared with fresh produce. It is one of India's largest industries, ranked fifth in terms of production, consumption and exports and valued at about $121bn with a 32-per-cent share of the total food market. It still has significant growth potential given that only 6 per cent of perishable goods are currently being processed. The Ministry of the Food Processing Industry, which is responsible for this sector's policy, has set a processing perishable goods target of 20 per cent of the segment's output by 2015.

Figure 3: Market structure of India's processed food segment




Source: Ipsos Business Consulting

Processed foods has many categories such as fruit and vegetables, milk and dairy products, alcoholic beverages, meat and poultry, marine products, grain processing, packaged/convenience food and packaged drinks/water. As with fresh foods, this segment is highly unorganised with much of the market occupied by myriad SMEs. However, many large fast-moving consumer goods (FMCG) producers, such as ITC, PepsiCo, Cargill Foods, Dabur, FreshFields and Nestle are present in this segment.

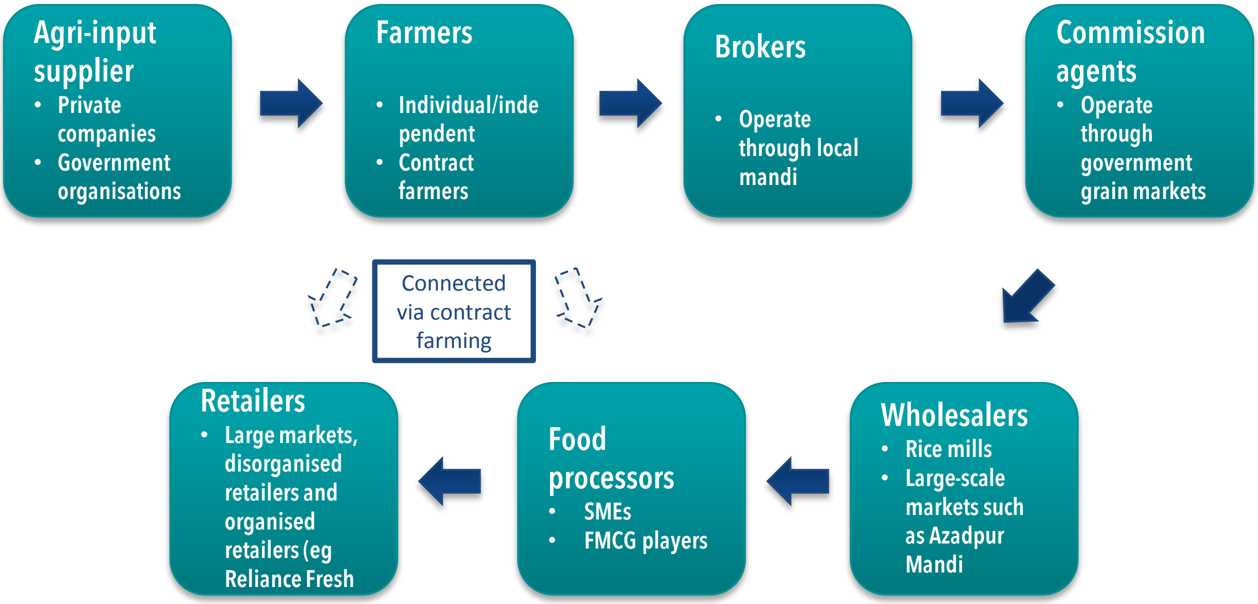
# Present value chain

The present value chain in fresh produce comprises agri-input suppliers, farmers, commission agents/brokers, wholesalers, food processors and retailers.

Usually the produce changes multiple hands before being purchased by consumers. Intermediaries in this value chain capitalise on the poor availability of price information and flawed government policies. This resulted in large markups at every level of the value chain which increased already high costs for consumers and slim margins for producers and farmers.

Some organised players such as Reliance and Future Group have started direct procurement through contract farming to cut out middlemen and avoid unnecessary mark-ups while assuring quality delivery by implementing professional supply-chain infrastructure and logistics.

Figure 4: The value chain of India's agri-food industry




Source: Ipsos Business Consulting

The government's liberalisation of cold-storage chain infrastructure, which allowed 100 per cent foreign ownership of firms operating, started reducing wastage in the distribution process. However, these gains were previously eroded by barring of foreign investment in retail operations until September 2012.

# Reforming India's retail policy

Government reforms allowing foreign firms to own up to 51 per cent of multi-brand retailers were implemented on 20 September 2012. The plans were initially tabled for the previous November, but the lack of political consensus within parliament and the ruling party caused delays.

Figure 5: Reform of India's foreign investment policy


The following measures were implemented to safeguard the interests of various stakeholders and to sustainably develop the retail sector:

1. **Provision** : Fresh agriculture produce, including fruits, vegetables, flowers, grains, pulses, fresh poultry, fishery and meat products, may be unbranded.
   **Impact** : This provision be positive for organised retailers with foreign investment as most such groceries purchased by Indian consumers are unbranded. However, retailers can still promote branded products to attract consumers looking for premium offerings.

2. **Provision** : At least half of any foreign investment shall be channelled into back-end infrastructure within three years of the first tranche.
   **Impact** : The agri-food sector is in critical need of such infrastructure, including warehouses, cold storage, refrigerated transportation and logistics. This provision will stimulate significant growth in the sector.

3. **Provision** : At least 30 per cent of the procurement value of SME-manufactured/processed products shall be sourced from small Indian companies whose total investment in processing and manufacturing does not exceed $1m.
   **Impact** : This is the most important provision for the processed food industry where three-quarters of the sector is comprised of unorganised firms and SMEs. The policy will enable them to build their market and optimise their capacity.

4. **Provision** : Government has first procurement rights for agricultural products.
   **Impact** : This provision increases uncertainty about supply for retailer players as government buying may result in insufficient quality supply for private firms. Farmers may also lose out on better purchasing prices offered by retailers.

Currently only nine states and one Union Territory allows foreign investment in retail. Major states such as Punjab, Uttar Pradesh, Bihar and Tamil Nadu are yet to grant approval. This slow adoption of the policy at state level may well limit potential benefits for the majority of farmers and processors.

# Policy impact on key stakeholders

The foreign investment policy will have an unprecedented affect on the agri-food sector. The most significant provisions are those relating to investment in back-end infrastructure and the requirement for 30 per cent of products by value to be sourced from SMEs. These policies will have major repercussions throughout the entire value chain to the benefit of some firms and the detriment of others.

Farmers, who are the most important link in the value chain, will largely benefit from the reforms. Currently, their key concern is obtaining the highest price for their produce with minimum wastage, reliable demand and access to timely inputs and information. Even after the foreign investment reforms, some domestic retail players – such as ITC, Aashirwad and Future Retail – are already showing signs of improvement. However, the benefits of foreign investment and the global best practices it brings with it will accelerate these improvements to the benefit of the entire sector.

With regards to improving farm product prices, a recent study in Himachal Pradesh found that while farmers earn about 40 per cent of the final shelf price by selling their products through the existing supply chain, this rises to 55 per cent when selling to retailers through a co-operative.

This positive earnings trend will only rise as foreign retailers increase direct purchasing from farmers to secure quality products with minimal wastage and shorter lead times.

Expansion of modern retailing will also drive consumer demand for newer, better products which will increase crop diversification as a result. This should help farmers leverage the latest technology and crop varieties to meet changing demand patterns.

Intermediaries such as brokers and commission agents will suffer from the increase in foreign investment as the government is also using APMCA to provide retailers/processors with more direct access to farm products. This is not seen as negative for the overall industry due to the inefficiency and increased consumer prices resulting from intermediate activity.

Unorganised SMEs, which account for most food processors, are in the best position to benefit from the 30 per cent sourcing requirement. Foreign investment in back-end infrastructure, which will increase supply-chain efficiency and reduce delivery times, will also improve access to quality output while bypassing costly intermediaries.

Domestic retailers, meanwhile, will gain access to the best global retailing has to offer, including management best practices and better utilisation of assets including real estate. This will stimulate growth within the retail industry, introduce new players and build the competitiveness of existing players who will be able to invest more in skilled manpower, back-end infrastructure and store networks.

The government, as a major stakeholder, will increase state coffers from higher tax receipts as retailing activity accelerates within organised channels. It will also gain support from organised players in the form of investment in back-end infrastructure which will help increase the system's overall productivity and efficiency.

# Impact on the retail industry

### Consolidation

Foreign investment will catalyse consolidation within the agri-food industry. To cater for increased demand from organised players, smaller food processors will need to scale-up operations which will see consolidation emerge as a key mechanism for leveraging economies of scale. Retailers also prefer to deal with medium and large-size suppliers who fulfil their demand.

### Infrastructure development

The sector currently suffers from poor infrastructure especially from insufficient warehouses and cold-storage facilities. This results in 30-35 per cent of products perishing during transportation which increases costs and reducing quality. Although foreign investment in cold chains was allowed in 2011, its scope was limited in terms of scale and scope which resulted in the sector remaining stagnant. Increased demand from the organised sector, however, will help it achieve scalability and more rapidly recover investments in assets.

The provision requiring half of foreign investment to be put in to back-end infrastructure will directly benefit the food processing sector. To secure supplies, retailers may well set-up their own food processing units.

### Contract farming

Various domestic players such as PepsiCo,  Reliance Fresh, and Future Group are already using contract farming methods ranging from direct procurement to open-source intermediation, where an operator provides farmers with up-to-date free information and capacity training on market prices, crop types and best cultivation practices without guaranteeing to purchase products. This practice will increase as new players look for better ways to obtain reliable, higher quality supplies with minimal lead-time.

### Market access

Presently food processors have limited access to farm produce as APMCA requires procurement to be routed through markets. The enforcement of the act is a state matter. However, the government is aware of the inefficiencies caused by the act and has already brought in the Model APMC Act, which the Ministry of Agriculture implemented in a bid to reform the sector by providing farmers with improved infrastructure and alternative marketing channels. Some states have started implementing the model act. The take up rate will increase as more local governments understand how foreign investment will increase output volumes and prices. It will create a level playing field granting all players, both large and small, equal access to farm produce.

### Niche products

The 30 per cent sourcing requirement will catalyse the food processing sector. Organised retailers usually focus more on private labels due to the better margins they enjoy compared to branded products. Such products are given more shelf space. Due to their small scale, food processors will be able innovate product varieties more easily and create niche products for new players seeking to attract consumers with the greater diversity of non-branded products.

For example, as organic food gains popularity in India, food processors are increasingly likely to enter this segment which will increase the cultivation of organic produce by farmers.

### Access to technology

New foreign players will introduce the latest food processing and agri-production technologies to India. Technology transfer to domestic players and local farmers and will lead to better products, higher productivity, improved capacity utilisation and increased efficiency.

# Conclusion

The new foreign investment policy takes a relatively cautious approach. It will intensify competition within the sector but safeguards in place should be sufficient to protect the interests of existing stakeholders. This in turn will have positive impact on agriculture and processed food sector.

Steps which reduce the role of middlemen in the market have the potential to improve profits for farmers while reducing product costs for consumers – this would be a very positive development. The arrival of international food retailers will accelerate technology and skills transfer within the industry, to the benefit of local firms. Requirements for foreign companies to invest heavily in supply chain infrastructure will increase efficiency and reduce wastage across the board. Overall, these measures could provide a blueprint for allowing increased foreign investment in other industries while ensuring domestic concerns are protected until they are strong enough to compete toe-to-toe with international operators.

However, there are some areas which require caution. Government must ensure the influx of foreign investment benefits Indian companies and farmers and reduces the cost of food for consumers. Furthermore, the state must be diligent in exercising its first-option rights for buying agricultural products. If this process is not carefully managed it will only increase downward pressure on farm incomes while potentially hamstringing the ability of foreign firms to develop the industry in a sustainable manner.

# Your Ipsos Contacts

## AUSTRALIA

### PERTH
Level 1, 1292 Hay Street
West Perth 6005
Perth, Australia
australia.bc@ipsos.com
Telephone 61 (8) 9321 5415

### SYDNEY
Level 13, 168 Walker Street
North Sydney 2060
NSW, Australia
australia.bc@ipsos.com
Telephone 61 (2) 9900 5100

## GREATER CHINA

### BEIJING
12th Floor, Union Plaza
No. 20 Chao Wai Avenue
Chaoyang District, 100020
Beijing, China
china.bc@ipsos.com
Telephone 86 (10) 5219 8899

### SHANGHAI
31/F Westgate Mall
1038 West Nanjing Road 200041
Shanghai, China
china.bc@ipsos.com
Telephone 86 (21) 2231 9988

### HONG KONG
22/F Leighton Centre
No 77 Leighton Road
Causeway Bay
Hong Kong
hongkong.bc@ipsos.com
Telephone 852 3766 2288

## INDIA

### MUMBAI
5th, 6th and 7th Floor, Boston House
Suren Road, Andheri (East) 400-093
Mumbai, India
india.bc@ipsos.com
Telephone 91 (22) 6620 8000

### NEW DELHI
C-1 First Floor
Green Park Extension
110 016
New Delhi, India
india.bc@ipsos.com
Telephone 91 (11) 4618 3000

## INDONESIA
Graha Arda, 3rd Floor
Jl. H.R. Rasuna Said Kav B-6, 12910
Kuningan
Jakarta, Indonesia
indonesia.bc@ipsos.com
Telephone 62 (21) 527 7701

## JAPAN
Hulic Kamiyacho Building
4-3-13, Toranomon
Minato-ku, 105-0001
Tokyo, Japan
japan.bc@ipsos.com
Telephone 81 (3) 6867 8001

## KENYA
Acorn House
97 James Gichuru Road, Lavington
P.O. Box 68230
00200 City Square
Nairobi, Kenya
kenya.bc@ipsos.com
Telephone 254 (20) 386 2721-33

## MALAYSIA
18th Floor, Menara IGB
No.  2 The Boulevard
Mid Valley City
Lingkaran Syed Putra, 59200
Kuala Lumpur, Malaysia
malaysia.bc@ipsos.com
Telephone 6 (03) 2282 2244

## PHILIPPINES
1401-B, One Corporate Centre
Julia Vargas cor. Meralco Ave
Ortigas Center, Pasig City, 1605
Metro Manila, Philippines
philippines.bc@ipsos.com
Telephone 63 (2) 633 3997

## SINGAPORE
11 Lorong 3 Toa Payoh
Block B #03-26/27/28
Jackson Square, S319579
Singapore
singapore.bc@ipsos.com
Telephone 65 6333 1511

## SOUTH KOREA
12th Floor, Korea Economic
Daily Building, 463 Cheongpa-Ro
Jung-Gu 100-791
Seoul, South Korea
korea.bc@ipsos.com
Telephone 82 (2) 6464 5100

## THAILAND
21st and 22nd Floor, Asia Centre Building
173 Sathorn Road South
Khwaeng Tungmahamek
Khet Sathorn 10120
Bangkok, Thailand
thailand.bc@ipsos.com
Telephone 66 (2) 697 0100

## TURKEY
Centrum Is Merkezi Aydinevler No:3
34854 Kuçukyali 3
Istanbul, Turkey
turkey.bc@ipsos.com
Telephone 90 (216) 587 1111

## UAE
4th Floor, Office No 403
Al Thuraya Tower 1
P.O. Box 500611
Dubai Media City, UAE
uae.bc@ipsos.com
Telephone 971 (4) 4408 980

## UK
Minerva House
5 Montague Close
SE1 9AY
London, United Kingdom
uk.bc@ipsos.com
Telephone 44 (20) 3059 5000

## USA
31 Milk Street
Suite 1100
Boston, MA 02109
United States of America
us.bc@ipsos.com
Telephone 1 (617) 526 0000

## VIETNAM
Level 9A, Nam A Bank Tower
201-203 CMT8 Street, Ward 4
District 3
HCMC, Vietnam
vietnam.bc@ipsos.com
Telephone 84 (8) 3832 982

agribusiness@ipsos.com

FOR MORE INFORMATION ON IPSOS BUSINESS CONSULTING, PLEASE VISIT OUR GLOBAL WEBSITE www.ipsosconsulting.com