

## Corpsec Hotline

January 12, 2012

### 100% FOREIGN DIRECT INVESTMENT IN SINGLE BRAND RETAIL ALLOWED!

After much deliberation and political fracas in the pursuit to open the multi brand retail sector to foreign investors, in order to boost the foreign direct investment ("FDI") inflows, the Indian government has further liberalized the single brand retail segment by allowing foreign investors to own up to 100% of the equity in a single brand retail entity in India. The Department of Industrial Policy and Promotion ("DIPP") of the Ministry of Commerce and Industry vide Press Note No. 1 (2012 Series) dated January 10, 2012 ("PN 1")<sup>1</sup> has permitted 100% FDI in single brand product retail trading under the Government route i.e. with the prior approval of the Secretariat for Industrial Assistance and the Foreign Investment Promotion Board.

### BACKGROUND

Prior to the PN 1, under the Consolidated FDI Policy issued by the DIPP vide Circular 2 of 2011 dated September 30, 2011 ("FDI Policy"), FDI in single brand product retail trading was allowed up to 51% under the Government route. Further, FDI in single brand product retail trading under the FDI Policy was subject to the following conditions:

- Products to be sold should be of a 'Single Brand' only.
- Products should be sold under the same brand internationally i.e. products should be sold under the same brand in one or more countries other than India.
- 'Single Brand' product-retailing would cover only products which are branded during manufacturing.
- The foreign investor should be the owner of the brand.

### REVISIONS MADE BY PN 1

Vide the PN 1, the FDI cap of 51% in single brand product retail trading has now been revised to up to 100% by the DIPP with an additional condition, other than the ones mentioned above, that where the FDI exceeds 51%, *"mandatory sourcing of at least 30% of the value of products sold would have to be done from Indian 'small industries/ village and cottage industries, artisans and craftsmen'."*

Compliance with this condition has been ensured through self-certification by the company, which would then be checked by the statutory auditors of the company from the duly certified accounts of the company.

For the purpose of the aforementioned additional condition, the term 'Small Industries' has been defined by the PN 1 as the ones *"which have a total investment in plant & machinery not exceeding USD 1 million. This valuation refers to the value 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."* Further, it has been provided that 'Village Industry'<sup>2</sup> shall have the meaning as defined under the Khadi and Village Industries Commission Act, 1956.

Thus, now, foreign investors may bring in FDI up to 100%, as opposed to the earlier 51% limit, provided they locally source from small and village industries, 30% of the value of the products sold by them.

### ANALYSIS OF THE AMENDMENTS MADE BY PN 1

- **Ambiguity in the expression 'value of the products sold'**: The DIPP has made it mandatory that, where FDI in single brand product retail trading is beyond 51%, *'30% of the value of the products sold'* would have to be sourced within India. However, it is unclear, as to whether 30% refers to the cost price or the selling price of the products, both having its own set of lacunas.

On a plain reading it may seem to suggest that, reference is to the price at which the product is or supposed to be sold. This leads to a highly onerous compliance requirement for foreign investors. Generally, luxury brands and other brands of international repute earn superlative profits due to the brand name they have acquired and maintain over a period of time. For such international brands, for whom the entire cost price of a product is less than 30% of the market value of the product, this added condition under the PN 1 would act as an impediment in bringing FDI beyond 51%. Further, this leads to a highly erroneous situation where either the foreign player would have to pay to the small industries an amount much higher than the value of the goods or services sourced from them or have a ceiling on the selling price of the products as at least 30% of the retail price will have to be paid to the small or village industries.

The other significant issue that this leads to is related to the quality of the products. Most international brands and even domestic brands are highly quality conscious and choose their suppliers with utmost care. An obligation to source 30% from the small or village industries may not allow these brands to maintain their quality levels and therefore it may discourage them from availing this higher FDI limit. There are numerous other issues that this 30%

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sourcing obligation will raise and be of concern; such as, there could be a genuine reason why a foreign investor cannot source from this sector due to the type of product, raw material required etc. How will such an issue be addressed? It may have been more prudent for the Indian government to have borrowed some policy precedent from the defence offset regulations where the obligation is to invest in the defence sector in India and is not limited to small or village industries.

- **Small Industry** : A 'small industry' has been defined in the PN 1 as an industry, which has an aggregate investment in plant & machinery below USD 1 million at the time of installation, without providing for depreciation. Such a definition poses its own set of challenges. Firstly, it may be highly difficult for international players to be able to source their requirements from a single 'small industry' on a continual basis depending on the business requirements of such international players. This could lead to a complex procurement chain and make the business inefficient for such international players. Secondly, as soon as the 'small industry' exceeds the USD 1 million cap the foreign investor will need to look for alternate options to fulfill the prescribed sourcing requirement. It will be next to impossible for the foreign investor to keep track of whether the 'small industry' concern is below the 1 million cap. It would have been more judicious for the Indian government to not restrict the sourcing from only the 'small industry' sector. Since development of this sector is of importance, more creative ways of funding could have been devised without interfering in the business models of single brand retailers.

## SUBSISTING ISSUES FOR FDI IN SINGLE BRAND PRODUCT RETAIL TRADING

There were various issues under the extant FDI Policy with respect to FDI in single brand product retail trading. The PN 1 has failed to deal with these issues and ambiguities, which continue to be present under the prevailing FDI Policy.

- **Owner of the Brand** : One of the major issues that is faced by international brands is due to the imposition of the requirement that the '*foreign investor should be the owner of the brand*'. This condition was introduced under the last version of the FDI Policy issued by the DIPP on September 30, 2011. It is common for companies to hold their intellectual property including brands, in separate IP holding companies or group entities for IP and/or tax purposes. These holding companies in turn license the brands out to their group companies or to third parties to whom exclusive territorial rights are provided. The requirement for the FDI investor to own the brand diminishes the structuring flexibility otherwise available while making investments. In addition, it does not appear to address any specific concern since the brand is still held within the same group or licensed as per standard international practice.
- **Single Brand** : Another existing condition imposed by the FDI Policy is that products to be sold should be of a 'single brand' only. This leads to uncertainty where there may be a single umbrella brand with sub brands under them. The Indian government should clarify that as long as the umbrella brand is a single brand and the sub brands are used with the single umbrella brand, it would be compliant with the extant FDI policy.

## CONCLUSION

This raise in the FDI cap in single brand product retail trading is a welcome change for the industry and the Indian economy as a whole. A much needed reform in a time of regulatory status quo. However, the imposition of highly onerous sourcing requirements is a significant dampener to the relaxation. The Indian government must re-consider the sourcing requirement and make it more business friendly to enable true foreign participation in the Indian retail sector. Alternate ways of funding the 'small industry' sector should be devised to create a win - win situation. Foreign investors could also be asked to play a role in such upliftment of the 'small industry' without impinging on their business models. More clarity is also required on some of the other conditions discussed above.

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You can direct your queries or comments to the authors

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<sup>1</sup> [http://dipp.nic.in/English/acts\\_rules/Press\\_Notes/pn1\\_2012.pdf](http://dipp.nic.in/English/acts_rules/Press_Notes/pn1_2012.pdf)

<sup>2</sup> "village Industry" means –  
(i) any industry located in a rural area which produces any goods or renders any service with or without the use of power and in which the fixed capital investment per head of an artisan or a worker does not exceed one lakh rupees or such other sum as may, by notification in the Official Gazette, be specified from time to time by the Central Government;  
Provided that any industry specified in the Schedule and located in an area other than a rural area and recognised as a village industry at any time before the commencement of the Khadi and Village Industries Commission (Amendment) Act, 1987 shall, notwithstanding anything contained in the sub-clause, continue to be a village industry under this Act;  
Provided further that in the case of any industry located in a hilly area, the provisions of this sub-clause shall have effect as if for the words "one lakh rupees", the words "one lakh and fifty thousand rupees" had been substituted.

(ii) any other non-manufacturing unit established for the sole purpose of promoting, maintaining, assisting, servicing (including mother units) or managing any village industry.

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