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Instructions to candidates:	**Candidates will be required to answer all questions.** Each question carries equal marks. **DO NOT TURN PAGE OVER UNTIL INSTRUCTED**

FDI in Indian Retail: More Hurdles for Walmart and Others

Knowledge@Wharton, June 2013

In September last year, when the Indian government allowed foreign direct investment (FDI) up to a level of 51% in multi-brand retail, it was expected that global players like Walmart, Tesco and Carrefour would move quickly. But the government has not received a single application until now. Onerous conditions and lack of clarity in the policy have been a big damper.

Key conditions in the initial policy guidelines include a minimum investment of US$100 million, of which 50% needs to be in back-end infrastructure; 30% of products must be sourced from small enterprises; and retail outlets can be set up only in cities with a population of over one million.

“We are waiting for greater clarity,” Tesco’s chief executive Philip Clarke told the media a few weeks ago after a meeting with the federal commerce and industry minister.

But recent clarifications from the department of industrial policy and promotion (DIPP) may only slow down the process further. The US$100 million investment requirement is a case in point. The government has now said that acquisition of existing retail stores will not be considered part of this mandatory investment. Global retailers will have to set up new front-end operations. The US$50 million mandated for back-end operations also has to be in creating greenfield infrastructure. The 30% products sourced from small industries cannot be used for global business, and fresh products do not fall under the ambit of the 30% sourcing. There are additional qualifying clauses, too.

“The spirit of the government announcement seems to be that there is no easy way to invest in retail in India. It is now clear that foreign players will have to create capacities from scratch. This means that they will need to go back to the drawing board, assess their appetite for investment and rethink their strategies,” says Ankur Bisen, vice president – retail, at New Delhi-based research and consultancy firm Technopak Advisors. Bisen feels that the new set of clarifications has “added more rigidity and disincentives and will result in further delay in investment decisions.”

Entrepreneur Meena Ganesh sees the clarifications as a “mixed bag.” Ganesh, who was earlier heading Tesco’s operations in India, says: “On the positive side, it is good to see the government clarifying key aspects and [removing] ambiguities …. It is also great to see that the government realizes and understands the need to create a strong back-end and supply chain network. On the negative side, this is disappointing since more restrictions and more rules will delay and dampen the interest of foreign firms. K. Ganesh, serial entrepreneur with strong experience in starting businesses in India, adds: “Not allowing the M&A route defeats logic, especially given the bureaucracy and startup hurdles in India. The make-or-buy decision or

organic-versus-inorganic decision, especially in early stages, is a commercial one."

Consider Walmart. It entered India in 2007 in a wholesale cash-and-carry format in partnership with Bharti Enterprises. WalMart expected that once FDI in multi-brand retail was allowed, this relationship would enable it to get a head start over other international retailers looking to establish a presence in India.

But Walmart has been embroiled in a series of controversies in the country. These include charges of violations of the Foreign Exchange Management Act and FDI regulations, and lobbying for FDI in multi-brand retail. (In India, lobbying is an illegal activity.) While the probe against lobbying has apparently been closed for lack of conclusive evidence, the company is still under scrutiny on other fronts.

In 2010 — prior to the opening up of FDI in multi-brand retail — Walmart made investments in Cedar Support Service, the holding company of Bharti Retail which has over 200 Easy Day stores in the country. A recent Walmart India statement regarding this says: "We are in compliance with India's FDI guidelines. All procedures and processes have been duly followed and details filed with relevant Indian government authorities, including the Reserve Bank of India." Responding to a query by India Knowledge@Wharton on Walmart's investment in Cedar, a Bharti Group spokesperson said: "We are in complete compliance of all regulations and will continue to do so."

Walmart's investments in Cedar in 2010 were by way of compulsory convertible debentures (CCDs). According to media reports, Walmart is now looking to convert the CCDs into equity and thereby get a 49% stake in Cedar. But, with the government mandating that all front-end investments have to be in greenfield ventures, Walmart may well have to rethink this move.

The company has another issue to worry about. Currently, the Bharti Walmart cash-and-carry stores reportedly sell 85% of their products to Bharti Retail's Easy Day stores. According to DIPP clarifications, Bharti Walmart will have to restrict its sales to Easy Day to 25% of its turnover. Or, it will need to reorganize its corporate structure. "I don't see the logic in this. A lot more clarity is required on this front," says Bisen.

In a conversation with India Knowledge@Wharton in September 2011, Raj Jain, president of Walmart India and managing director and CEO of Bharti Walmart had said, "If FDI does not open in the next three years or so, then that may require a rethink on the whole strategy, because … you can't monetize all your investments just on cash-and-carry." Now, Walmart's rethink on strategy may have to come thanks to the fine print in India's FDI policy.

Indian retail chains that were looking to dilute their stake to the multinationals will also need to go back to the drawing board. "They will now find it difficult to attract foreign retailers. This will be a big jolt to them." says Bisen. Adds Ganesh: "This seems to favor the very large industrial houses … as they can fund their ventures all the way through to an IPO. It will give them a

competitive advantage as it will restrict the number of players. Any such scenario is not good for free markets and the consumer."

S. Ramesh Kumar, professor of marketing at the Indian Institute of Management Bangalore (IIMB), offers another perspective. Pointing out that India is "a unique market with a large chunk of retailing happening in the unorganized sector across several categories," Kumar says: "With modern retail registering considerable growth in recent times, the government's clarification [on FDI in multi-brand retail] is perhaps a relief for the unorganized market."

According to Kumar, without the stringent clarifications announced by the government, multi-brand FDI retailers might have brought "several value-based offerings at the lower end of the market." He suggests that "while consumer groups may benefit out of these offerings, the unorganized sector, both retailers and local brands … would be significantly affected." Kumar adds: "The condition regarding the creation of back-end infrastructure by the multi-brand [global retailers] can contribute to the professional and gradual development of suppliers. Since this would be gradual, the unorganized sector, too, will have time to adapt."

To Be Made Here, or Elsewhere — a Look inside Outsourcing Decisions

Knowledge@Wharton, July 2013

Global companies struggle with decisions on how much to outsource. Too little means an organization may lose the pricing advantages that can come with using competitive providers worldwide. Too much — or the wrong kind of outsourcing — and quality and knowledge management can suffer.

A panel at a recent Wharton Global Forum in Tokyo titled, “Global Supply Chain Management: Outsourcing, Re-shoring, and Near-Shoring,” looked at the reshaping of the global supply chain, and how companies choose where and whom to source from in a fast-changing environment. During the discussion, led by Wharton professor of operations and information management Morris A. Cohen, the panelists suggested that the cheapest solution is not always the best, and that the architecture of supply chains can vary widely depending on the industry and products involved.

Boeing’s supply chain evolves from extensive research into customers and the environments in which they operate, said Beth Anderson, a Boeing vice president. “We go through the entire cycle of designing the airplane and designing the production system, and understanding who our customers are going to be and how we’re going to support [the aircraft] once it goes into service.”

Boeing’s main customer base has evolved since 20 years ago, when 75% of the company’s production took place in the United States and Europe, with the rest happening elsewhere. Now, just 25% of Boeing’s backlog is in its traditional markets in the U.S. and Europe, with 75% in fast-growing economies like China and India. Thus, Boeing’s vast supply chain is evolving to fit its changing market and advancing technologies.

Last year, the manufacturer sourced 783 million parts used to build 600 aircraft. By 2014, it will be bringing in more than one billion parts from a total of 7,500 suppliers to build 700 planes. “It’s a vast supply chain and very complex,” Anderson said of the 500,000 people in 73 countries engaged in helping to build Boeing products. “It [takes] really well choreographed logistics … to bring those airplanes together.” She noted that even a seemingly simple window shade is sourced from seven suppliers.

Like most manufacturers, Boeing is contending with immense competition, and that means its choice of suppliers has to enhance its competitive advantage. Ultimately, “it all comes down to safety,” Anderson said. Each of Boeing’s 7,500 suppliers is held to the same standards the company requires of itself. Optimizing its supply chain and other qualities such as fuel efficiency and aerodynamics enabled Boeing to gain 35% in efficiency between 1975 and 1995, but airlines are demanding still more improvements. “Our world has changed dramatically,” Anderson noted. “To be competitive, we are working with our supply chain. We’re looking at whom we work with, [and] how we change the engineering, the architecture.”

Boeing's manufacturing processes have been in the spotlight lately because of the company's high-tech 787 Dreamliner, which suffered from delays, cost overruns and, after its launch, high-profile battery problems. Last week, an empty 787 Dreamliner caught fire while parked at London's Heathrow Airport. Boeing, along with Great Britain's Air Accidents Investigation Branch, the U.S. National Transportation Safety Board and Honeywell, maker of the emergency device located in the area where the fire appeared to be burning, is investigating the possible causes of the incident.

Ultimately, Boeing seeks to minimize risk and maximize the value of its supply chain by gauging the capability, capacity, collaboration, cash and commitment of its suppliers. It also has to work with aspiring partners in emerging markets such as China, despite potential risks from technology transfers. "It's a balancing act. We don't want to say, 'No, we're not going to share,' because we would be shutting ourselves out of the market. But we have to decide when we have to say no," Anderson noted.

Where, and How Many?

Japanese aircraft maker and defense contractor Mitsubishi Heavy Industries, whose company has worked closely with Boeing on the 787 and other planes, is also balancing its domestic manufacturing base with the need to expand into global markets, said Shigefumi Tatsumi, the company's vice president and general manager for commercial aircraft. The company makes at most 50 of its best-selling aircraft in a month, with lead times that are often over a year. "We have a very flat supply chain, which is not good for the current business environment," noted Tatsumi. Key considerations are location and quality assurance.

Nissan Motors faces similar challenges, according to Vincent Cobee, corporate vice president in the automaker's Global Datsun Business Unit. Nissan's supply chain, like Boeing's, has been transformed by globalization and the emergence of newly affluent markets outside of North America, Europe and Japan. The shift of production to offshore markets to help defuse trade friction ended the traditional reliance of Japanese automakers on marketing through the big Japanese trading houses. That transition was followed by a shift toward localization across many markets.

While Nissan maintains full control over development of its vehicles, it has had to localize supply chains to reduce costs and reach its key markets. The automaker uses several different business models. The premium brand, Infiniti, is competitive with German luxury cars and developed and made in Japan. The global Nissan product is developed in Japan but localized for various markets. Finally, there is Datsun, which Cobee calls a global-local product, developed and sourced locally with Japanese expertise.

For high-tech products, supply chain logistics can be even more daunting, said Kenji Mizuno, a senior vice president in electronics maker Fujitsu's supply chain management unit. Unlike aircraft and cars, Fujitsu's products are often invisible to consumers, but there are similar pressures to ensure that

goods are delivered quickly enough to meet customers' requirements. Fujitsu counts among its clients nearly half of all Fortune 500 global companies and it is the world's third-largest IT service provider, with 173,000 employees and 4.4 trillion yen in annual sales.

Rather than thousands of suppliers, Fujitsu relies on only a handful for each of the many components used in its X86 servers, which Mizuno cited as an example. It buys CPUs from Intel and AMD, and hard disc drives from Seagate and Toshiba. The realities of the supply chain, and high expectations of Fujitsu's customers, mean that Fujitsu has to source parts from suppliers that have moved offshore to China and elsewhere in Asia, and keep costs low, while providing high quality and high reliability and managing grueling time limitations.

Despite the small number of suppliers, Fujitsu must provide servers tailored to meet up to 20,000 configurations, Mizuno said. Fujitsu's solution to the dilemma of scattered suppliers and short delivery times of five or six days is to buy parts from China or from members of the Association of Southeast Asian Nations (ASEAN), ship them by sea freight and have them ready for final assembly close to its customers' locations in Japan, Europe and China. "We assemble the products, put them through long tests and deliver. This is the only scenario that allows us to make money and meet all the other requirements," Mizuno noted.

To manage its myriad supply chains, Fujitsu has opted for a "virtual global SCM" (supply chain management system) to decide who will make and deliver products. "We are doing this every day. We look at the customer orders, factory lines and parts supplies. This is the only way we can do it," Mizuno said. Tokyo Electron, which makes the chip sets used in Sony Play Stations and other devices, faces similar requirements for high reliability and quality but has a less open approach to its own supply chain, noted Akihisa Sekiguchi, the company's vice president and general manager for corporate marketing. Tokyo Electron produces mainly for export, though only eight customers account for almost all its business.

No Single Solution

Although it is not that well-known to consumers, Tokyo Electron once was number one in the integrated circuit industry, back when Japan was the leading manufacturer of semiconductors. Now, it is at the top in Japan and number three in the world, with 12,000 employees and $5 billion to $7 billion in annual sales. The firm's manufacturing is all done in Japan, though it ships 90% of its products overseas. "Our R&D is global, but sourcing is domestic," Sekiguchi said. Keeping production onshore works for Tokyo Electron because the components needed to make its tools are made in Japan, and the country's infrastructure can support its manufacturing.

Apart from trials related to years of "endaka," or the high-valued yen, Tokyo Electron's biggest challenge came with the March 2011 earthquake and tsunami, which forced its factory in Fukushima to close for about two months. The company's workers pulled together to get production back up as soon as possible, though "it takes time to track down 4,000 or 5,000 suppliers,"

Sekiguchi noted. Calamities like the March 2011 disasters drove home the need to mitigate risk through multi-sourcing. But it does involve costs. “It’s not an easy solution,” Sekiguchi said. “IP protection is an issue. Geographic location is an issue.”

Ultimately, there is no single solution that works in all cases. The question of IP protection is vital to supply chain management, Cohen noted during the panel discussion. But for companies like Boeing, the extremely high degree of regulation typically helps to prevent bogus parts from getting into the industry. “Mostly the regulators do the policing. We just ensure that all the parts have the right documentation,” Anderson said.

Automakers like Nissan face much greater risks, given the prevalence of independent auto service companies in many markets. “It’s very difficult to guarantee the source of the parts. Our badge is on the car no matter where the parts come from,” Cobee noted. “I recommend not using an unauthorized dealer in China.”

Partly out of those concerns, some consumers are choosy about the origin of the products they buy. But for IT companies like Fujitsu, although components are made in various places, from Costa Rica to Israel, “we can boast that our products are made only in Japan,” said Mizuno. “The real issue is reliability and capability. We do very special tests, and sometimes many components fail. But when we deliver the finished computers, they are very high quality. That’s our expertise. They are made and assembled in Japan with our technology.”

Tokyo Electron, likewise, uses components from overseas but puts its products through extensive testing before they are shipped. “If components fail, they are dropped,” Sekiguchi said of the tests, which extend to the “molecular level. In the semiconductor industry, we buy the product, not the location or the source.”

Stretching to reach global markets involves risks, as Boeing’s experience with the 787 attests. Yet, outsourcing is something Boeing will continue to do, even if the company found that it went a bit too far with the Dreamliner.

“We had an expectation that our suppliers could do the same things that we do every day. We learned that stuffing an airplane full of parts, [something that] we take for granted, is … challenging,” Anderson noted. “We’ll take our expertise and start getting the next new airplane on the books. We’re taking advantage of the expertise around the world. We can’t believe we’re the only ones who can do it.” According to Tatsumi of Mitsubishi Heavy Industries, working with Boeing is an elaborate process involving hundreds of engineers and a collaboration that has to evolve as the products and market environment change.

Companies must realize that once they have opened the door to collaboration or outsourcing, though, it can never be closed, noted Nissan’s Cobee. Given the huge risks of failure for products like automobiles and many other products, “you have to think about not only the benefit for tomorrow but also about whether you can sustain it.” To keep a competitive edge requires

constant innovation. “You have to innovate more than the others. Yes, we have the daily job of protecting IP. It doesn’t take a genius to dismantle a car and reverse engineer it,” Cobee said. “The only way is innovation.”