



DISCOUNT APPAREL BRANDS: TIME TO DO AWAY WITH THE 'DISCOUNTS'?

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Overview

The Indian apparels market has witnessed a paradigm shift in consumer demand to ready-made, branded apparels from traditional, tailor stitched apparels custom-made to measurements. In order to capture a larger market share and also build their respective brands, several market participants adopted a steep discounting strategy, whereby they offered discounts throughout the year in the range of 50%-90% on the printed Maximum Retail Price (MRP). The high MRP allowed these participants to maintain their operating profit margins in the range of 13%-18% despite these heavy discounts.

Prior to the latest Union Budget for 2011-12, apparels like readymade garments and made-ups were under an optional excise duty¹ regime. Manufacturers of readymade apparels could opt not to pay excise duty and thereby not claim the Cenvat credit on the inputs used for manufacturing these apparels. As per the applicable excise laws, they could claim Cenvat credit if they decided to pay excise duty at the rate of 5% for goods made of pure cotton and 10% for other apparels. However, most of the manufacturers abstained from paying excise duty mainly due to the associated transaction and administrative costs thereby making readymade apparels excise duty free.

In the Union Budget for 2011-12, the optional excise duty levy was changed into a mandatory levy at a unified rate of 10% for branded garments with abatement of 55%. The change was effected to bring the branded readymade garments under the purview of excise under the impending Goods and Service Tax regime, where exemptions are not favoured. Initially the abatement was proposed at 40%. Consequent to stiff resistance from garment manufacturers/retailers across the country, the abatement was increased to 55%, which reduced the effective rate of excise duty to 4.5% from the proposed 6.0%. Under the new excise rules, the manufacturers are allowed to avail Cenvat credit on inputs however there are only a few inputs on which Cenvat credit could be claimed. This is because most of the inputs are under optional excise duty, leaving little room available for set-off.

Within the branded garments space, apparel discount brands are likely to be the most affected due to the imposition of mandatory excise duty and has the potential to distort their cost structure. The MRPs of discount brands are disproportionately higher than the final sales prices. In addition, discounts are offered throughout the year. Therefore, the implication of

¹ Under optional excise duty, manufacturer is allowed to choose the option of paying applicable excise duty and claim credit of tax paid on inputs, capital goods and input services or not paying the excise duty and not claim input tax credit

excise duty as a percentage of actual realisation is much higher for discounted brands than non-discounted brands. As per ICRA estimates, effective excise duty² would work out to 10%-45% for brands offering discounts between 50%-90%.

Under the new scenario, discount brands have three alternatives to maintain their cash inflows at earlier levels: a) increase MRP while maintaining discounts at the same levels b) reduce discounts with the same MRP/ share excise burden with customer c) reduce the MRP. Table 1 outlines the first strategy under which discount is maintained as before but the MRP is increased.

Table 1: Increase MRP without any change in discount rate

	Old	New without MRP increase	New with MRP increase
Discount	50%	50%	50%
Excise duty rate	0.0%	4.5%	4.5%
MRP (Rs.)	3,000	3,000	3,296
Price for Customer (Rs.)	1,500	1,500	1,648
Excise duty (Rs.)	0	135	148
Effective excise duty	0%	9%	9%
Net revenue *	1,500	1,365	1,500
Discount	90%	90%	90%
Excise duty rate	0.0%	4.5%	4.5%
MRP (Rs.)	3,000	3,000	5,455
Price for Customer (Rs.)	300	300	545
Excise duty (Rs.)[#]	0	135	245
Effective excise duty	0%	45%	45%
Net revenue*	300	165	300

Note: *Net revenue= MRP*discount rate – excise duty outflow; #Excise duty rate *MRP *(1-abatement)

Source: ICRA Analysis

- a) In order to maintain the same level of net revenues and discount rate, discount brands will have to increase their MRPs exponentially with rising discounts. In the above example two scenarios have been worked out to illustrate that the range of mark up in MRP could be between 10% and 82% for passing the entire excise duty burden to consumers. In order to offer 90% discount, the marked-up MRP works out to incredibly high level of Rs. 5,455 for a Rs. 300 garment. The excise duty payout and effective price for the customers will be the highest in this scenario thus rendering this option least attractive.
- b) Alternatively, brands can lower the discount levels to maintain the same levels of cash inflows without doing away with their discount model. In such a scenario, customers will have to bear 9-45% higher charges for the same garments, thus rendering discount brands less attractive. The burden for the customers rises rapidly with rising discounts, as illustrated in Chart 1.

In addition, the manufacturers/retailers may choose to absorb the excise duty partially and lower the burden on customers, thereby making a negative impact on their own cash flows. Even if the manufacturers bear 50% of the cost increase on account of the excise duty, the increase in the effective price for customers could be in the range of 5%-23% depending on the level of discount. However, manufacturers of discount brands do not have much headroom to absorb additional levies, as rising input costs had put pressure on their profitability. For instance, the average operating profit margins of discount brand apparel manufacturers dropped to 10.7% in FY2011 from 15.3% in FY2010. Further, any drop in the sales volumes of discount brands is likely to make a significant impact on their profitability on account of their high fixed operating costs structure owing to associated debt like characteristics such as operating-lease

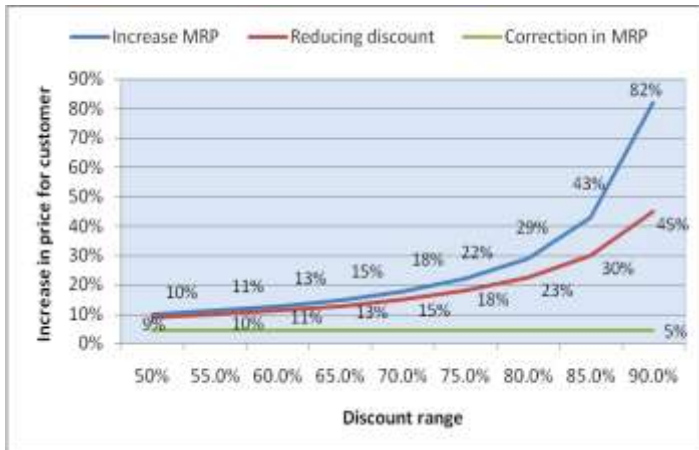
² Effective excise duty: excise duty/MRP*(1-Discount Rate)

commitments, large investments made in retail stores and higher inventory levels as a result of single distribution channel of exclusive brand outlets.

Given the intense competition, ICRA expects that reduction in discounts while maintaining MRP at the same levels may not be sustainable over the long term, as the effective excise duty is much higher than what is levied in the budget. In fact, even premium brands have resorted to increased discounts to liquidate inventory. Additionally, discount brands are facing stiff competition from private labels of the large format chain retail stores such as Shoppers Stop, Pantaloons, Westside, Reliance Retail, and Spencer’s among others that are aggressively promoting their own labels while offering value-for-money proposition to their customers. In the last few quarters, discount brands have suffered from slowing sales growth and even decline in sales in some cases, thus squeezing their cash flows. Pressure on sales along with large and slow moving inventory in the books may make a significant impact on the liquidity of discount apparel manufacturers. Therefore, it is very clear that there is pressure on discount brand manufacturers to maintain their growth trajectory.

- c) Reduction in MRP: In options a) and b), passing on the higher burden may not be easy for discount brands as their pricing power is generally low on account of price sensitivity of value conscious customers and overall low level of brand loyalty. Any increase in price may, therefore, have an impact on the demand for such discount brands. In ICRA’s view, correction in MRP seems to be the most feasible option for discount brands because the increase in the burden on the customers is minimal while cash inflows for the manufacturers remain intact. However the idea of discounting, on which the business model is based, could be challenged if the companies choose not to offer discounts but lower the MRP.

Chart 1: Impact on the effective price for the customers



Source: ICRA Analysis

As offering of large discounts is an integral part of the pricing strategy of such brands, with discounts generally offered throughout the year, there may be a shift in the marketing strategy of discount brands. Due to mandatory excise duty, discount brands may correct their MRPs and start following the conventional route, whereby promotions and discounts are typically limited to end-of-season sales organized to clear unsold inventory in preparation of the new season. As per the discussion above, correction in MRP seems to be the only viable approach in

the prevailing environment for branded apparel manufacturers as well as their customers, as the effective price increase for the customers can be limited at around 5% while the cash inflows of the companies could be maintained. Discount apparel brand manufacturers may also choose not to correct their MRP fully and continue to offer low discounts in the range of 10%-20% throughout the year. However, it remains to be seen whether such companies are ready to renounce their distinctive marketing strategy of offering high discounts throughout the year.



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