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# Chazen International Study Tour Report Great Expectations: The Rise of the Indian Middle Class

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**Runner-Up,  
Outstanding Study Tour Report Award**

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### A Note from the Authors

A group of 40 Columbia Business School students visited India in January 2008 through a student-organized trip supported by the Chazen Institute of International Business. Our trip organizers were Talib Saiffee, MBA '08, and Sangeeta Abkari, MBA '08. We were accompanied by Professor Hitendra Wadhwa of the Marketing Division, who told the Indian growth story from both academic and personal perspectives. Holly Ferris of the Chazen Institute also joined us. During our time in India, we met with business and government leaders who provided perspectives on opportunities and challenges presented by the economic advances of the world's largest democracy.

### Chazen International Study Tours

Designed to enhance the classroom curriculum, Chazen International Study Tours offer students and their faculty adviser an intense, firsthand experience of the business and culture of their chosen country or region. Study tours are initiated by students and organized with the help of the Jerome A. Chazen Institute of International Business. During the study tours, students meet with leading executives and government officials while visiting businesses, factories and cultural sites. Destinations change yearly, as study tours are student-initiated. Recent destinations include Brazil, China, India, Japan and South Korea.

PHOTOGRAPHIC CONTRIBUTIONS: HOLLY FERRIS AND JU RHYU MBA '08.

## Executive Summary

India's middle class is on the rise. If India's economy continues to grow as predicted, by 2025 the Indian middle class will number 583 million people, or 41 percent of India's projected population,<sup>1</sup> almost twice the current population of the United States. These educated and predominantly urban wage earners, whose income ranges from roughly US\$24,000 to \$118,000 on a purchasing-power-parity basis,<sup>2</sup> have fueled India's recent consumer growth and represent the country's future. With the ongoing rise of the Indian middle class comes an increasing appetite for goods and services: the housing market is booming, the financial-services sector is expanding, telecommunications is undergoing a "revolution" and retail is moving upscale. And this is just the beginning.

Constantly seeking new consumers, multinational companies are eager to satiate the appetite of this attractive burgeoning market. From Wal-Mart to Louis Vuitton, international retailers are fighting to increase their presence in India. Undeterred by heavy regulation of foreign companies and encouraged by signs of an opening of the Indian economy, foreign companies are finding inroads and expanding their footprints in the country.

Despite the Indian middle class's growing purchasing power and multinational companies' eagerness to cater to this demographic's needs, the country still has much to do to ensure that the middle class can enjoy the standard of living to which Western countries have become accustomed. To get there, India must first solve its physical infrastructure problems. In a land where electrical blackouts are still common and gridlocked roads often cause fresh produce to rot before it even gets to market,<sup>3</sup> life can be harsh and the cost of doing business can be unnecessarily high. Next, while progress is being made in reducing bureaucracy, burdensome regulations continue to plague Indian businesses, including banks and retailers. Populist legislation often slows business and dampens competition. While solving any of these problems will be no small feat, India cannot afford to ignore them if it wants to secure the promised growth of its middle class.

## Housing Needed

India has a serious housing shortage. We noticed that even before our plane landed. Whereas high-rise residential buildings pepper the skyline of Shanghai and Singapore, a 20-story building

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<sup>1</sup> Eric D. Beinhocker, Diana Farrell and Anil S. Zainulbhai, "Tracking the Growth of India's Middle Class," *McKinsey Quarterly*, August 2007, p 56.

<sup>2</sup> *Ibid.*, p. 55. Middle class is defined in this study as those earning between 200,000 and 1,000,000 rupees per year, or between US\$5,000 and \$25,000. This is roughly equal to US\$24,000 to \$118,000 on a purchasing-power-parity basis.

<sup>3</sup> One-third of India's produce rots before coming to market according to Edward Luce. Edward Luce, *In Spite of the Gods: The Strange Rise of Modern India* (New York: Random House, Inc., 2007), p 88.

is still a rarity in Mumbai. The lack of supply drives up housing prices. In Mumbai's most desirable neighborhoods, apartment prices rival those in New York or London. As India's middle class expands, the call for adequate housing is becoming more widespread.

India's housing shortage presents tremendous opportunities for the private sector. DLF, India's largest developer, is at the forefront of this national housing boom. While DLF historically has focused on commercial properties, it is now moving into housing for the Indian middle class.<sup>4</sup> Our visit to the company took us through DLF City, a 3,000-acre township located on the outskirts of Delhi. The development, which contains office complexes, commercial spaces, high-rise apartment buildings, a golf course and country club, is, as the name suggests, a city unto itself. And Delhi is just one of 30 Indian cities where DLF has projects or land awaiting development. The company has more than 250 million square feet of projects that are either developed or under development and has nearly 750 million square feet in total land holdings.<sup>5</sup>

DLF is but one firm among India's many other property-development enterprises. We also spoke to Adi Godrej, chairman of the Godrej Group, about his company's expansion into residential



Building India: One rod at a time.

real estate. The Godrej Group, a large Indian conglomerate that has interests in everything from consumer retail products to real estate, has begun construction of what we were told will be the tallest residential building in Mumbai. Increasing competition from international property developers is expected to ease the tremendous demand for affordable housing in India.

Despite the growing number of property developers, real estate development is still not keeping pace with the surge in demand in India. For one, Indian property development is labor-intensive, and construction technology is relatively primitive and inefficient—for example,

the bamboo scaffolding in the photo above of a development site near New Delhi; at this building site, more than a dozen laborers were used to hoist metal rods by hand, one at a time, up a

<sup>4</sup> Jackie Range, “‘Building India’: DLF’s Big Gamble,” *Wall Street Journal*, January 17, 2007.

<sup>5</sup> DLF presentation to Columbia Business School students on January 7, 2008, and the company Web site, [www.dlf-group.com](http://www.dlf-group.com).

makeshift structure. According to executives at DLF, foreign expertise will improve the quality and speed of construction, making housing more widely available on a timelier basis.

India's myriad regulatory processes and various land-use laws constitute additional reasons for delays in construction. For instance, large-scale land aggregation often requires the use of multiple entities, as Indian "land ceiling laws" limit the total plot size that can be owned by a single party.<sup>6</sup> "Land use law in the past has been generally arbitrary, quite unrealistic," said Rajiv Singh, vice chairman of DLF, in an interview with the *McKinsey Quarterly*.<sup>7</sup> The result of complex regulation is ineffective use of much urban land. While the country is trying to reduce governmental red tape, it still is not willing to relinquish control over land. The government continues to "maintain a very detailed system of property market controls in its largest cities such as Mumbai, which has some of highest land values in the world."<sup>8</sup>

### Financial Institutions in India: On the Up and Up

On the third attempt and after a half-hour search, we could finally withdraw money from an ATM in India. The country will truly need more effective and more abundant financial services to support its booming middle class. India's newly ascendant consumers will need financing to buy homes, cars and other big-ticket items. The country's savers will need a place to invest their newfound wealth.



Bandra: Mumbai's financial district has seen the benefits of India's red-hot financial sector.

Our visits with ICICI Bank and Citi India gave us a perspective on how far the country's financial institutions have come and what is yet to be accomplished. Much of India's population has no access to financial services. This presents both a problem and an opportunity. Effectively issuing credit to the "unbanked" population would further facilitate the anticipated growth of the Indian economy, estimated to grow at 8–9 percent per annum over the coming years,<sup>9</sup> and offer hundreds of

<sup>6</sup> Ranjit Pandit, "Putting a Roof Over India: An Interview with the Country's Biggest Developer," *McKinsey Quarterly*, November 2007, p. 42.

<sup>7</sup> Ibid., p. 41.

<sup>8</sup> Luce, *In Spite of the Gods*, p. 98.

<sup>9</sup> Economist Intelligence Unit, *Country Report: India*, January 2008, p. 2.

millions of Indians the opportunity to lift themselves out of poverty. India's banks can rise to meet this need. To put the opportunity in perspective, even after the tremendous growth of recent years, all of the Indian banks combined are currently smaller than one of the largest Chinese banks.<sup>10</sup> Needless to say, there is room for growth.

The banks that successfully solve the issues associated with lending to Indian middle-class and lower-middle-class consumers will gain a tremendous foothold in India. ICICI has certainly demonstrated great success of late, with the company's net profit rising 35 percent in the last quarter and deposits increasing by 33 percent.<sup>11</sup> Part of its success has been attributable to early penetration in many rural markets. It has been able to apply a microfinance strategy similar to the one Muhammad Yunus pioneered in Bangladesh through Grameen Bank, one that relies in part on community ties for its effectiveness.<sup>12</sup> Through this process, ICICI has been able to achieve "near zero" default rates with double-digit gross margins, according to Nachiket Mor of ICICI.<sup>13</sup> While we were impressed by this, Mor also highlighted the difficulties faced in distributing this type of finance on a macro level as well as the fact that, because community ties are not as strong in urban areas as they are in rural areas, this model will not work as well for the urban population.

India's urban middle class will need a more traditional credit-based lending system, including a modern credit bureau. Rakesh Kaul of Citi India highlighted that one of the biggest problems facing the retail-lending market is an underdeveloped credit bureau. Currently, the Indian credit rating system is in its infancy, which poses a substantial challenge for the tracking of individuals' credit histories. To help solve this problem, ICICI is discussing the use of biometric identification systems, which use unique physical identifying characteristics such as fingerprints to help track individuals in a country where many people share the same name and where background information on people is often spotty at best. These systems would allow customers to access accounts and establish a credit history. Resolving these issues will help provide credit to India's new urban middle class.

While lagging in some areas, the Indian banking system excels in others. Indian financial firms have embraced technology, a mindset highlighted by K. V. Kamath, CEO of ICICI, in an

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<sup>10</sup> Citi India presentation to Columbia Business School students, January 3, 2008.

<sup>11</sup> John Satish Kumar, "ICICI Bank's Net Soars with Indian Economy," *Wall Street Journal*, January 21, 2008, online edition.

<sup>12</sup> Microfinance banks traditionally lend to poor women in rural areas. The women form a collective of 5 to 10 members. The microfinance bank will then lend money to the collective, with the women of the collective effectively guaranteeing each other's repayment of the loan. The model relies on the strong social ties in rural populations. For more information about Grameen Bank and microfinance in general, see Evaristus Mainsah et al., "Grameen Bank: Taking Capitalism to the Poor," *Chazen Web Journal of International Business*, Spring 2004, [http://www2.gsb.columbia.edu/journals/files/chazen/Grameen\\_Bank\\_v04.pdf](http://www2.gsb.columbia.edu/journals/files/chazen/Grameen_Bank_v04.pdf).

<sup>13</sup> By comparison, Grameen Bank's recovery rate is 98.28 percent. Grameen Communications, "Grameen Bank at a Glance," <http://www.grameen-info.org/bank/GBGlance.htm>.



interview with the *McKinsey Quarterly* in which he said that the chief information officer role was so ingrained in ICICI's business that it is part of his CEO role.<sup>14</sup> The bank cites this focus on technology and efficiency as a primary reason for ICICI's ability to compete internationally.

At home, the Indian banking system remains largely protected from international competition. For example, multinational companies are allowed a limited number of retail locations. Despite having been in India since 1902, Citi has only 39 bank branches and 443 ATMs in India.<sup>15</sup> The company blames its limited retail presence on government restrictions, which appear to have been effective in allowing Indian companies to catch up with competitors from abroad. The question remains as to when the regulations will be relaxed. Further opening of the financial sector is currently slated for 2009, but that seems optimistic. As Mor of ICICI put it, "[International banks] keep waiting for this magic 2009 wand. Nothing is going to happen in 2009." The Indian middle class will need financing and a competitive financial sector. Opening up the Indian financial sector will ensure increased competitiveness.

## Telecom Revolution

As our local trip organizer chatted away on his Bluetooth phone, looking like a suave Indian James Bond, it became clear that India is indeed in a telecom revolution. Companies in the cell-phone market offer innovative products to meet the unique demands of this country. For example, providers are working to offer non-English-language handsets, important in a country with 22 official languages, such as Hindi and Punjabi. With no credit bureau and limited credit-card usage, the prepaid-cell-phone model accounts for an estimated 90 percent of revenues in this market. However, unlike in other countries where customers purchase prepaid cards to add phone credits, in India credits can be added electronically through distributors.

Cell-phone services are also quite affordable. During our meeting with Bharti Airtel Limited, India's largest cell-phone service provider, we were told that India benefits from some of the lowest telecommunications tariffs in the world. Domestic calls cost about 1.5 cents a minute; the average user spends approximately \$9 per month.

Low cost and innovation have led to an addition of eight million cell-phone subscribers every month. According to the *Economist*, the average Indian handset owner spends 471 minutes each

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<sup>14</sup> Leo Puri, "The CEO as CIO: An Interview with the Head of India's Top Private Bank," *McKinsey Quarterly*, March 2007, p. 4.

<sup>15</sup> Citi India presentation to Columbia Business School students, January 3, 2008.

month on the phone.<sup>16</sup> If India's middle class grows to the estimated 583 million people and each subscriber spends 471 minutes on the phone each month, the potential opportunities that exist in India's cell-phone market are tremendous. International cell-phone service providers are keenly aware of these opportunities, as evidenced by Vodafone Group's recent acquisition of Hutchison Telecommunications International, a fast-growing Indian cell-phone company.

However, as we also experienced firsthand in India, much more infrastructure is needed before these opportunities can be seized. Like many Indians, we experienced frustrations with our local phones, which often seemed programmed to produce only busy signals. We then discovered during our meeting with Bharti Airtel that busy signals are caused by a nationwide scarcity of bandwidth. With large sections of the spectrum reserved for the military and so-called G3 technologies, the country's 250 million subscribers have insufficient bandwidth for carriers to provide the same level of quality found abroad. The result: dropped calls, bad reception and overall poor connectivity.

### Retailing in India: Here Come the Multinationals

Walking down the streets of Mumbai, we felt like we were on New York City's Canal Street again—small vendors ruled. While it is nearly impossible to find everything you need in one shop, you never have to walk far for a soda. India, we were told, has traditionally been a “land of petty shops and traders.” Mom-and-pop stores dominate the landscape. In a meeting with Adi Godrej of the Godrej Group, we were told that the group's fast-moving consumer goods (FMCG) division alone distributes to an estimated eight million retail outlets in India.

Marketing to retailers requires an India-specific strategy, which generally means catering to small vendors. Packaging, for instance, is smaller in rural areas, where many farmers' total purchasing power is often equivalent to the money in their pocket. India's predominantly rural population of roughly 750 million people and poor infrastructure require companies such as Godrej to carry huge inventories because of long lead times. The cost of servicing far-flung rural areas is high. With many links in the supply chain, determining price points is an art. The landscape is now changing, though. The growing middle class and urban migration have increased the need for larger and more up-scale shopping facilities.

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<sup>16</sup> *Economist*, “Does Not Compute,” November 8, 2007, [http://www.economist.com/specialreports/displaystory.cfm?story\\_id=10053304](http://www.economist.com/specialreports/displaystory.cfm?story_id=10053304).



Big-box retailers, such as Wal-Mart and France's Carrefour, are not blind to India's retail potential but seemed curiously absent from the Indian landscape. Foreign direct investment in the retail space has been tightly regulated. The fear is that large international corporations will put India's small retailers out of business. Currently, Indian law allows international companies to sell only one brand per store—Nike sells at a Nike outlet, Lacoste at Lacoste and so on. To start tackling such regulatory constraints, large retailers are planning to partner with Indian firms. Bharti Airtel, for instance, has an agreement with Wal-Mart, the terms of which have not been disclosed.

Wandering through the high-end shops and hotels in Delhi and Mumbai, we also noticed that luxury brands have arrived in India. Many of us, unschooled in the subtleties of high-end retail, were given a crash course on luxury brands—Hermès, Louis Vuitton, Dior. That luxury retail has come to India, however, should come as little surprise. According to the *McKinsey Quarterly*, affluent India's share of national private consumption will reach 20 percent by 2025.<sup>17</sup> We met with Karen Wilson Kumar, retail country manager for Louis Vuitton, one of the front-runners in India's luxury race. Arriving in the country in 2002, the company has been encouraging the government to open up the luxury-goods sector to foreign investment. Until recently, international companies were allowed to own only 51 percent of an Indian subsidiary in this retail sector. Luxury brands also face high tariffs (up to 35 percent) and a scarcity of adequate retail space. Tariffs, however, are dropping, and Emporio, DLF's new luxury mall in Delhi, will open up prime space for luxury retailers.

## Indian Infrastructure

"So, how long does it take to get there?" we asked on our way from West Bandra to Vikhroli East, which are only about eight miles apart. "It could take 30 minutes; it could take three hours. It all depends on the traffic," we were told. The overcrowded and hazardous streets of India are just one more reminder of the obvious: India's infrastructure is ramshackle and woefully inadequate for a country of 1.1 billion people. To support the larger-scale consumption of India's upcoming middle class, more physical infrastructure is desperately needed. The problem with cars is that you need roads.<sup>18</sup> The problem with electric utilities is that you need electricity. Urban migration will add more people to India's cities, stressing an already strained infrastructure. Kaul of Citi India estimates that a half trillion dollars of investment in

<sup>17</sup> Beinhocker, Farrell and Zainulbhai, "Tracking the Growth of India's Middle Class," p 57.

<sup>18</sup> The Tata Group has recently developed a car that will cost \$2,500. While this low-cost vehicle will make owning an automobile more attainable, it likely will do little to ameliorate India's already heavy traffic.

infrastructure is needed over the next five years. India's ability to support a large middle class will depend on its abilities to address these issues.

During our trip, we came face-to-face with some of the more egregious aspects of India's infrastructure challenges. A simple cab ride in Mumbai is a memorable experience, one where you learn that there truly are no rules on the road. We had the pleasure of experiencing the train system in Mumbai. It is difficult to convey in words the experience. Men practically fight to be able to hang off the side of the train. The ports, both air and sea, are also vastly outdated. During our short stay in Delhi, we experienced at least six power outages at our hotel, a well-respected international brand.

Infrastructure, however, is improving. According to numerous accounts, things work better than they did 5 to 10 years ago. Godrej highlighted that it now takes him seven minutes to get out of the airport in Mumbai, when it used to take him hours. Thank goodness for small things! This progress is encouraging and will be necessary to support India's new middle class.



Infrastructure in India: Congestion ahead.

## Parting Thoughts

India's economy, which grew 9.7 percent last year, is creating a new demographic—the Indian consumer. This expanding Indian middle class has created a boom in construction, financial services, telecommunications and retail. This is just the beginning of an economic expansion that promises to benefit hundreds of millions of people in the world's largest democracy. In order to sustain this growth, however, India must address several constraints on its economy. If India can address these issues, the best is yet to come.

We look forward to returning to India. We thoroughly enjoyed the country's rich cultural history, warm hospitality and gastronomic pleasures (although sometimes accompanied by gastrointestinal displeasures). Having visited the country in the early stages of an opening of the economy and a consumer boom, we look forward to telling our friends and families one day, "We were in India back when . . . ."