E-Commerce in India on the Rise

Skadden

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Despite the headwinds facing Indian e-commerce start-ups, some of which had irrational cost structures and business models based solely on discounts, the overall success and potential of this sector, as well as its attractiveness to foreign investors, cannot be ignored.[1]

While China and the U.S. are currently the largest e-commerce markets in the world, India is the fastest-growing.[2] The sector was valued at $3.8 billion in 2009 but has grown significantly every year since. In 2016, despite being hit by the effects of the Modi government's demonetization scheme, the sector grew by 55.5 percent, to $16 billion, and is expected to reach as high as $47.5 billion by 2020.[3]

Recent Changes to FDI Policy

E-Commerce

Foreign investment in certain sectors in India requires compliance with a complex set of rules and regulations. The rules relating to foreign investment in e-commerce companies and developments in the industry have evolved significantly over the past year.

An "e-commerce" business under India's foreign direct investment (FDI) policy is defined as one involving the "buying and selling of goods and services over a digital and electronic network." Prior to 2016, foreign investment in e-commerce companies was not specifically regulated, and as a result, there was ambiguity about whether such investments should be treated as investments in a multibrand retail business (*i.e.*, such as Target and Kmart), which is a regulated sector subject to caps on foreign ownership.

The most common interpretation of the rules prior to 2016 was that a multibrand retail business did not include marketplace-based model of e-commerce[4] (such as eBay) because these marketplaces did not maintain their own inventory. Accordingly, foreign investment was permitted in such marketplace businesses but not in e-commerce companies holding their own inventory. However, such marketplaces failed to take off in India due to the lack of committed supply, and these companies had to find ways to source exclusive sellers for their platforms while at the same time remaining eligible for foreign investment. Several e-commerce companies adopted innovative structures in response, such as having one entity operate a marketplace platform (in which foreign investment was not restricted) and another (which would be subject to foreign ownership limits) source goods from manufacturers, hold inventory and sell goods through the marketplace platform.[5] Others established non-Indian wholesalers to source goods, hold inventory and sell to friendly Indian-owned sellers, who would in turn resell through the marketplace to consumers.

In March 2016, the Indian government amended the foreign investment regulations to clarify the existing regulatory landscape and specifically allow e-commerce companies with 100 percent foreign investment that operate a marketplace business to proceed

[1] Skadden, Arps, Slate, Meagher & Flom LLP (and its affiliated law firm entities) are not qualified to practice Indian law. This article is based on publicly available information and is for general informational purposes only.

[2] See "India growing fastest in e-commerce, says study," *YourStory* (Feb. 12, 2017).

[3] See "Demonetisation impact: Indian e-commerce growth projection cut to 55.5% for 2016," *Mint* (Dec. 7, 2016).

[4] "Marketplace-based model of e-commerce" is defined as the provision of an information technology platform by an e-commerce company on a digital and electronic network to act as a facilitator between buyer and seller.

[5] See "India formalises 100% FDI in e-commerce marketplace with riders," *VCCircle* (March 31, 2016).

under the automatic route (*i.e.*, without prior government approval). Certain conditions apply, including that companies must not:

(i) have more than one vendor account for more than 25 percent of sales on their marketplace; and

(ii) directly or indirectly influence the sale price of goods being sold.

The rules also made clear that foreign investment in companies operating an inventory-based model of e-commerce (*i.e.*, where the company owns the inventory) is not permitted.

The new restriction on no single vendor accounting for 25 percent of sales has compelled leading players (*i.e.*, those with only one or two captive sellers accounting for a majority of sales) that had adopted the structures mentioned above to change their business models again. In addition, the restrictions on influencing prices has affected the sector's ability to compete effectively against brick-and-mortar retail outlets.

Single-Brand Retail

Under the FDI policy, single-brand retail entities that sell their products through brick-and-mortar stores also are permitted to sell their products through the internet and are eligible for 49 percent foreign investment under the automatic route (and beyond that, with governmental approval).

Consumer Protection Law

Growth in the e-commerce sector has resulted in a significant rise in the number of consumer complaints against e-commerce companies.[6] The government has recognized a need to protect online consumers and has included specific provisions governing e-commerce transactions in a newly proposed consumer protection bill, which would replace the decades-old Consumer Protection Act of 1986. Among other proposals, the bill would broaden the definition of "consumer" to include persons buying goods or availing services online through electronic means. In addition, the bill would impose specific obligations on "electronic intermediaries"[7] in order to assist the various Indian local consumer redressal authorities in settling consumer disputes — including requiring them to provide all information and records that the authority will need to evaluate the dispute.

Recent Efforts to Promote E-Commerce

Digital India

"Digital India" is a government initiative that aims to improve India's digital infrastructure and increase access to information technology services, particularly in semirural and rural areas. India's mobile phone subscriber base recently reached 1.12 billion,[8] and the country had 391 million internet users as on December 31, 2016, according to the Telecom Regulatory Authority of India. This number is expected to nearly double by 2020 according to a NASSCOM-Akamai report.[9] Since an increase in mobile devices and access to affordable mobile data and internet services is a key driver of the e-commerce sector, the government's initiatives for promoting internet connectivity are expected to boost growth of e-commerce transactions in the future.[10]

Demonetization

The Modi government's decision to demonetize its 500 and 1,000 rupee notes (approximately US$7.50 and US$15, respectively), which accounted for over 85 percent of currency that was in circulation, adversely affected all retail trade, including e-commerce, in 2016. India is largely a cash economy, and fewer than 30 million people have credit cards.[11] The "cash on delivery" offerings of e-commerce companies accounted for a majority of their online orders, and sales were badly hit due to a shortage of new currency. However, in the long run, demonetization is expected to push consumers toward cashless transactions and alternative payment methods, which will ultimately make it easier for consumers to shop online and enhance the e-commerce ecosystem. Digital wallet providers, for example, have already seen jumps in activations.

Challenges

Independent Online Sellers

An association of online vendors that sells products on popular e-commerce sites recently approached the Ministry of Commerce and Industry alleging unfair market practices by e-commerce players and sought help with payment settlement disputes. The Ministry of Commerce and Industry has directed the association to approach the Department of Consumer

[6] See "Infographics: Consumer complaints in India against e-commerce giants at a record high," *WION* (Feb. 9, 2017).

[7] "Electronic intermediaries" are defined as anyone who provides technologies or process to enable manufacturers, traders and other persons to engage in the advertising or selling of various goods or services to customers, and includes online marketplaces and online auction sites.

[8] See "Reliance Jio additions power telecom subscriber base to 1.12 billion: Trai," *Mint* (Feb. 3, 2017).

[9] See "India will have 730 million internet users by 2020, govt says," *The Times of India* (March 27, 2017).

[10] See "AMI: Digital India mission to boost India's e-commerce," *InfotechLead.com* (Sept. 24, 2015).

[11] See "India has 28.8M credit cards, 818M debit cards in January 2017," *MediaNama* (March 7, 2017).

Affairs.[12] This has highlighted the need for specific norms and, perhaps, a dedicated grievance redressal forum governing the relationship between online sellers and e-commerce companies.

Other Retailers

As expected, brick-and-mortar retailers have not been happy with the steep discounts e-commerce companies have offered in a bid to increase their consumer base. (As noted above, e-commerce companies have pursued a discounting-dependent strategy in order to build market share.) Retailers' associations in India comprising several large players recently filed petitions with the government questioning foreign investment in the e-commerce sector and seeking a level playing field.[13] These petitions appear to be partly responsible for the government's regulating foreign investment in the marketplace model and mandating that such e-commerce entities maintain arm's-length pricing. However, such tensions are not unique to India, and examples from other countries suggest that the Indian retail sector is undergoing an irreversible change that will ultimately benefit Indian consumers, albeit to the detriment of brick-and-mortar retailers.

[12] See "E-commerce payment disputes: Commerce Ministry tells sellers group to approach consumer affairs ministry for resolution," *The Indian Express* (March 17, 2017).

[13] *All India Footwear Manufacturers & Retailers Association v. Union of India* (W.P. (C) 7479/2015); *Retailers Association of India v. Union of India* (W.P. (C) 5034/2015). See "FDI in retail: Rising demand for a 'level playing field,'" *IndiaCorpLaw* (March 13, 2016).

Conclusion

Despite challenges, India's e-commerce sector is expected to grow significantly in the coming years with the increasing purchasing power of Indian consumers, the government's initiatives for building better physical and digital infrastructure and the overall growth of India's economy. In recent years, several Indian technology companies such as Flipkart, Snapdeal, Paytm, ShopClues and Quikr, among others, have been able to raise significant foreign capital from private equity and venture capital investors, and we expect this trend to continue. However, metrics such as overall value or number of transactions on a platform is not the key driver for investors anymore, and, as in other regions, valuations appear to be moderating. In fact, many of the recent fundraisings by Indian companies have been down-rounds.

In addition, several large multinational technology companies have established operations in India either directly or through strategic relationships with Indian partners, as evidenced by Alibaba's investment in digital payment and e-commerce company Paytm, Ctrip's investment in travel website MakeMyTrip and Tencent's investment in the messenger app Hike, among others. We also expect to see consolidation in the sector with many large domestic players looking to acquire smaller rivals. This is clear from the flurry of recent acquisitions including Flipkart-owned Myntra's acquisition of rival Jabong, MakeMyTrip's acquisition of rival Ibibo, budget hotel booking app Oyo Rooms' acquisition of Zo Rooms, and many more.[14]

[14] See "What major e-commerce acquisitions in 2016 tell us," *YourStory* (Dec. 16, 2016).