

Into the Spiritscape: Understanding competitive forces in the Indian alcohol industry

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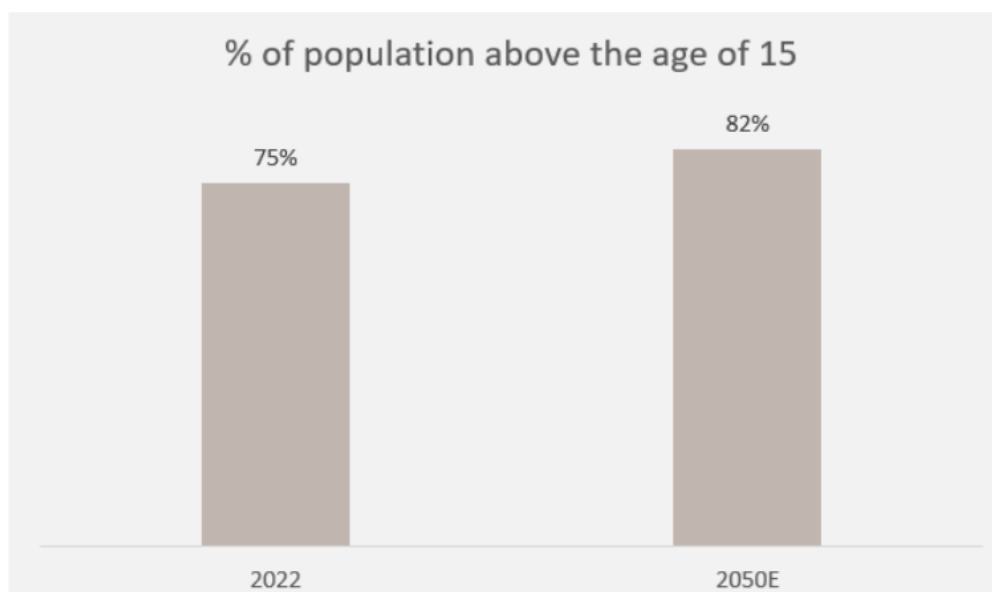
Understanding competitive forces in the Indian alcohol industry

In the world of business analysis, simplicity often conceals profound insights. Michael Porter's Five Forces framework, exemplifies this principle. Despite its straightforward approach, the framework has demonstrated remarkable effectiveness in unraveling the intricate dynamics of industries.

Let's quickly take a look at the five forces.

- **Threat of Substitutes:** This force considers the availability of substitute products or services that can fulfill the same need as the industry's offerings. High availability of substitutes can weaken the industry's attractiveness.
- **Threat of New Entrants:** This force examines the barriers to entry for new companies in the industry.
- **Bargaining Power of Suppliers:** This force analyzes the influence suppliers have over the industry. Suppliers with strong bargaining power can demand higher prices or favorable terms, impacting the costs of providing a product/service.
- **Bargaining Power of Buyers:** This force assesses the influence customers have on the industry. Buyers with strong bargaining power can demand lower prices or higher quality products, affecting the profitability of industry players.
- **Intensity of Competitive Rivalry:** This force examines the level of competition among existing companies in the industry. Factors such as price competition, product differentiation, and market saturation can influence the intensity of rivalry.

In this note, we delve deeper into the Indian alcohol industry by leveraging Porter's five forces. But before, we get to the framework, let's take a closer look at India's alcohol industry.

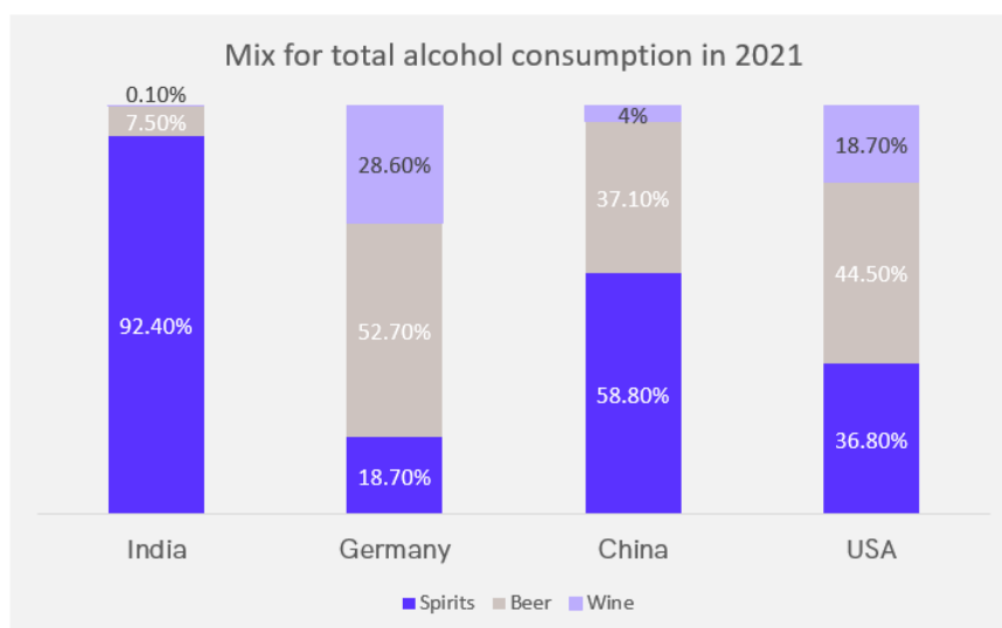


Source – United Nations, *World Population Prospects (2022)*. Projects based on UN Medium Fertility scenario.

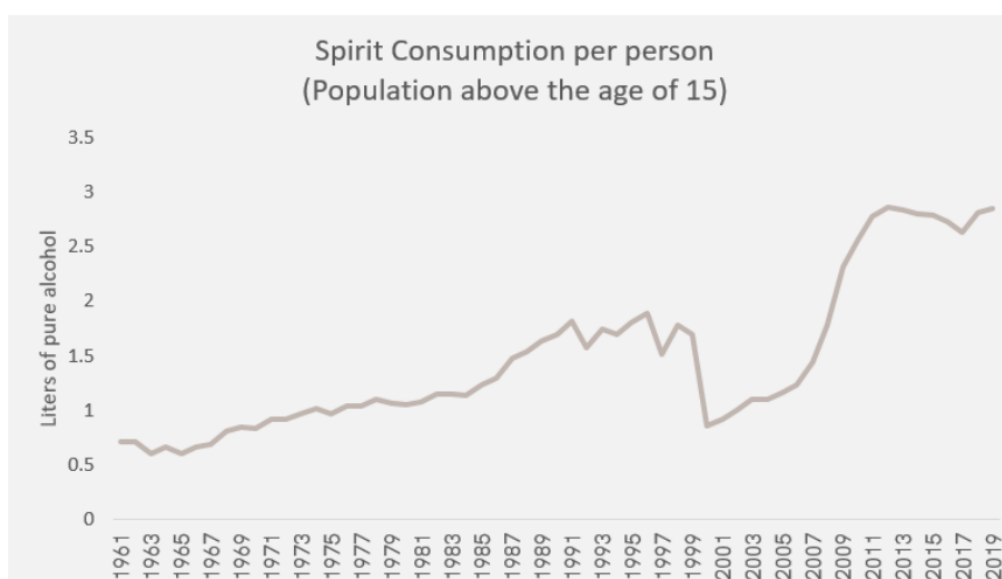
Perhaps, the promise in the sector (and the nation) lies in the demographic mix. Approximately 25% of the country's population is below the age of 15, highlighting how young the nation is. Furthermore, 25% of India's population exceeds the entire population of the United States. Talk about scale! With a growing number of individuals reaching the legal drinking age, the Indian alcohol industry is poised for significant growth. Furthermore, this growth, has a long runway, given that even in 2050, as per current estimates, more than 300 Million people in India will be below the age of 15.

If we look at current consumption, it's clear that India is a spirit loving nation. A staggering 92% of all alcohol consumed in India in 2021 was through spirits.¹

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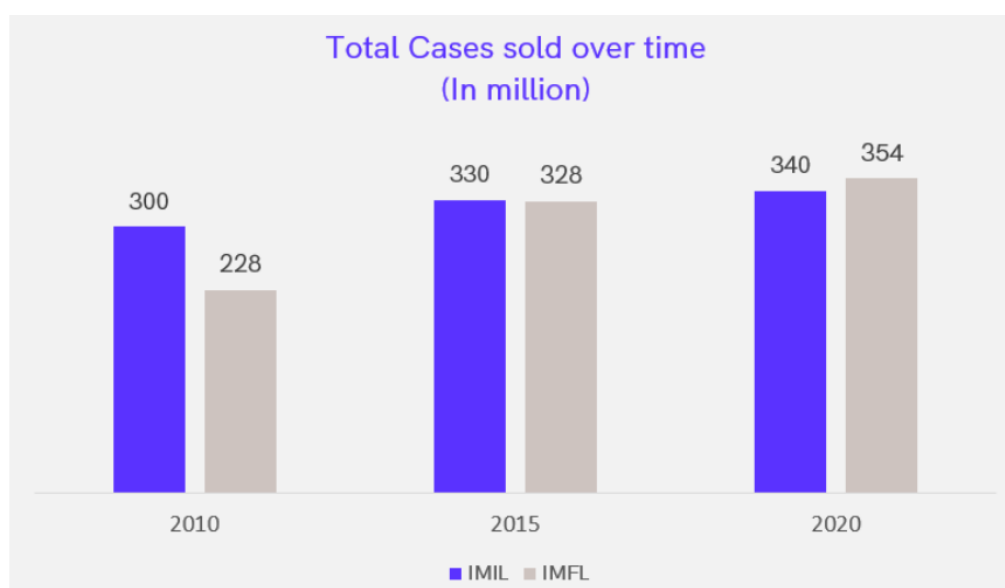
Source – Technopak Analysis, Allied Blenders DRHP



Source: WHO Global Health Observatory (GHO)

With a GDP per capita close to \$2500² as of 2023, affordability plays a crucial role in determining the alcohol mix in India. Spirits, with their higher alcohol content and shelf-stability, become an attractive choice. They offer a stronger punch, while keeping expenditure in check. Even within spirits, it is crucial to distinguish between Indian Made Indian Liquor (IMIL), and Indian Made Foreign Liquor (IMFL).

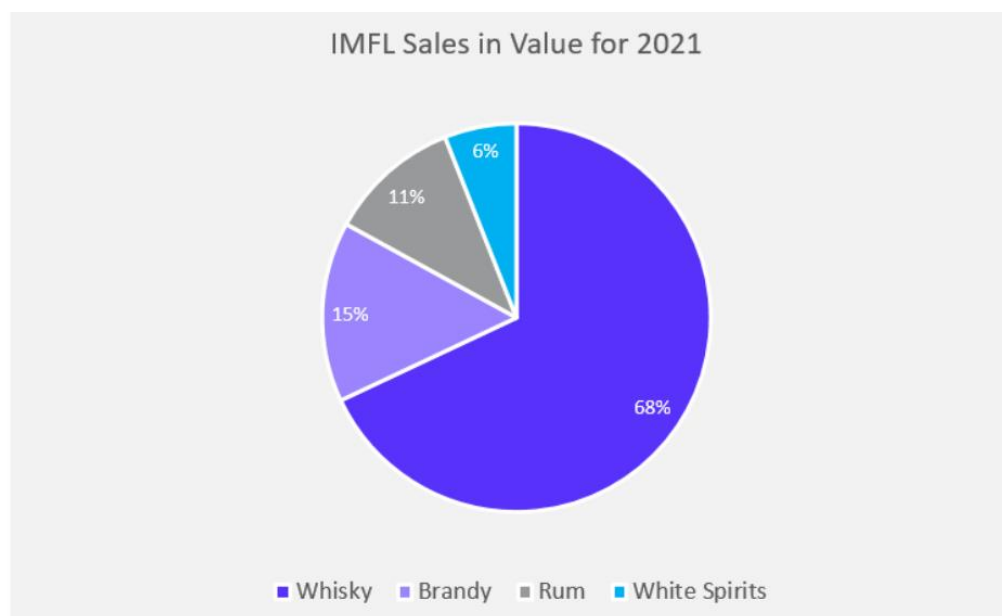
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Source: Technopak Analysis, ABD DRHP

IMIL, refers to country liquor, a distinct category within the beverage industry. It is typically produced using traditional methods and local ingredients, reflecting the regional flavors and preferences of consumers. Country liquor faces restrictions and bans in some regions of India. (particularly in the Southern states)

On the other hand, IMFL encompasses a wide range of alcoholic beverages such as whiskey, brandy, rum, gin, tequila, vodka, and more.



As the chart above shows, within IMFL, whiskey is the clear leader, followed by brandy, rum and white spirits. With that introduction let's get to Porter's five forces.

Threat of new substitutes

“Survived for 9000 years. Can it for another 9000?”

Throughout history, alcohol has played a significant role in human culture and social interactions. Its roots can be traced back as far as 7000 BC in the Neolithic period³, with evidence of early alcohol production discovered in ancient China and other regions. From those early days to the present, the methods of alcohol production may have evolved, but the relevance of alcohol in society has not relinquished.

This long and storied history of alcohol, spanning over 9,000 years, raises an intriguing question: Are there legal substitutes in India, that can replicate the unique allure and experience provided by alcohol?

Short answer? Not really.

Rising disposable incomes in India are expected to have two crucial impacts on the Indian alcohol industry.

- Shift from country Liquor to Indian Made Foreign Liquor (IMFL): With increasing discretionary incomes, consumers have the means to upgrade their drinking preferences. As a result, we are witnessing a noticeable shift from country liquor to Indian Made Foreign Liquor (IMFL). We are also witness premiumization in IMFL, and expect this to continue.
- Beer & wine growth: As consumers experience a boost in discretionary income, they are more inclined to incorporate alcohol into their lifestyle beyond merely seeking intoxication. This shift leads to a change in drinking habits, with individuals opting to consume alcohol more frequently, integrating it into social gatherings, meals, and other experiences, but in smaller quantities. Consequently, this trend fuels the growth of beer and wine. In turn one can expect them to gain some market share from spirits.

However, the key question here lies beyond beer and wine. It revolves around the search for legal alternatives that can replicate the intoxicating buzz and effects offered by alcohol. While beverages like mocktails, non-alcoholic beers, energy drinks, soft drinks, coffee and herbal concoctions exist, they do not truly serve as substitutes for alcohol. They may provide alternative flavors and experiences, but they lack the ability to replicate the distinctive impact and sensations that alcohol delivers.

Interestingly, in certain countries, there has been a decline in alcohol consumption per capita. This trend could be attributed to the emergence of legal alternatives and/or a growing awareness of the health risks associated with alcohol consumption. For instance, a study conducted in Colorado found that the legalization of recreational cannabis was associated with a 13% decrease in purchasing for all alcoholic beverages⁴.

Another recent study conducted by policy scientists from the University of Pittsburgh School of Public Health, found that states that legalized recreational cannabis experienced a slight population-level increase in alcohol consumption, particularly among young adults and men⁵. These studies have different conclusions, indicating that the impact of legal alternatives on alcohol consumption are still ambiguous.

Could India see such a decline in alcohol consumption due to substitutes? Unlikely. As of 2016 data, close to 53.5% of Indians above the age of 15, have never had any alcohol⁶. That number is expected to go down over time due to changing societal norms as well as rising incomes. While we may witness changes in the types of alcohol consumed, the fundamental desire to experience a state of intoxication remains a dominant factor in shaping consumer choices. And as of now, there aren't too many legal substitutes that can replicate this experience.

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Threat of new entrants

“Crashing a party?”

Multiple structural factors combine to create significant barriers for potential new entrants:

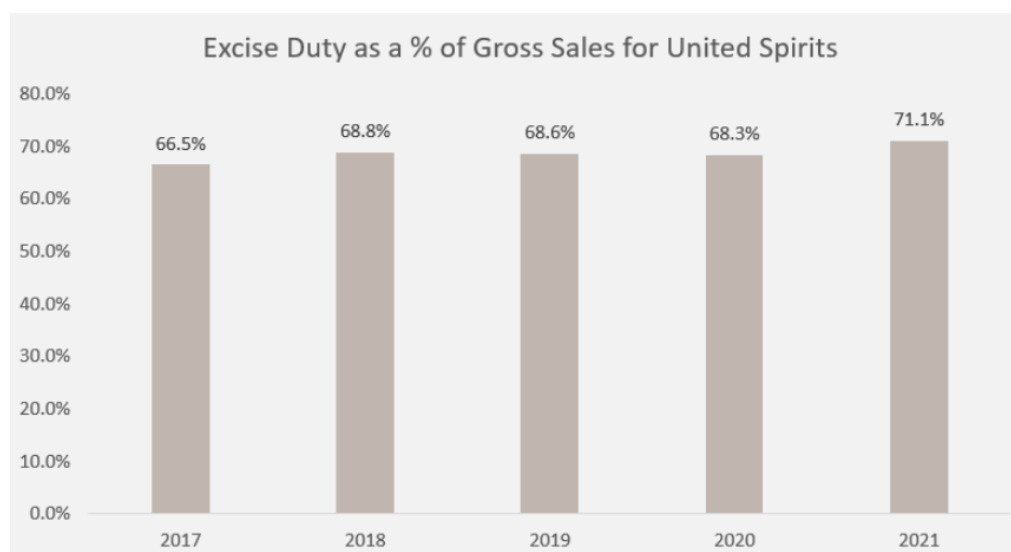
1. Inability to Advertise

The alcohol industry in India faces significant restrictions on advertising. Stringent regulations prohibit companies from promoting the production, sale, or consumption of alcoholic beverages. This hampers new entrants’ ability to build brand awareness, establish a market presence, and effectively compete with established players who benefit from their already recognized brands.

2. Duties and taxes

The imposition of high import duties on alcoholic beverages creates a significant barrier for new entrants looking to introduce international brands or products into the Indian market. These duties significantly increase the cost of importing alcohol, limiting the price competitiveness and profitability of new entrants compared to established players with local production facilities. While Free Trade Agreements (FTAs) may potentially bring down some of these import costs, navigating the complex landscape of trade agreements and ensuring their effective implementation remains a challenge.

In addition to import duties, excise duties also pose a significant burden on alcohol producers in India.



Source – Company report & Investec Research

Furthermore, the varying rates of excise duties across different states further complicate the landscape, making it necessary for companies to navigate a complex web of regulations and tax structures.

3. Highly Regulated Sector

The alcohol industry in India is highly regulated, with various state-specific regulations and licensing requirements. Obtaining licenses to produce, distribute, and sell alcohol can be a complex and time-consuming process. Additionally, distribution and pricing are often controlled by state authorities, further complicating market entry.

4.Reaching Scale

For all the reasons mentioned above, achieving scale in the alcohol industry poses significant challenges. Companies need to build production facilities, establish extensive distribution networks, and invest in impactful marketing campaigns. To thrive in the alcohol industry, one must have deep pockets and be prepared to weather losses for a few years. For instance, despite its popularity, the Indian craft beer brand Bira is yet to turn a profit⁷. New entrants who manage to achieve moderate scale may find themselves becoming acquisition targets for larger companies.

To put it simply, breaking into the Indian alcohol industry is like trying to crash a party. You do not have an invite and are greeted by a bouncer. Chances are you are spending a lot of money just to enter.

Bargaining power of buyers

“The government found a golden goose.”

The bargaining power of buyers in the Indian alcohol industry varies depending on the state-level supply chain. To illustrate this, let’s consider the examples of Maharashtra and Karnataka.

In Maharashtra, as of 2023, the state permits private distributors and retailers to directly purchase alcohol from the companies that produce it, provided they acquire the necessary license. This regulatory framework fosters an open market environment, allowing for the participation of multiple buyers. As a result, both the companies producing alcohol and the retailers have greater flexibility in conducting their business operations.

On the other hand, in a state like Karnataka, as of 2023, the distribution of alcohol is controlled by a state government-owned entity. As a result, the bargaining power of retailers, is relatively lower. They have limited options and are subject to the pricing and terms dictated by the state-controlled entity.

In fact, there are numerous different distribution models, across India.

Maharashtra	The state permits private distributors and retailers to directly purchase alcohol from the producers.
Karnataka	State government owned entities purchase alcohol from producers and sell it to private retailers.
Tamil Nadu	State government owned entities have control over both wholesale and retail sales.
Madhya Pradesh	State government-owned entities operate warehouses where they store company stocks. Retailers then acquire stocks from these corporations, and invoices are generated based on the retail inventory lifted from the warehouses.
Gujarat	Alcohol is prohibited.

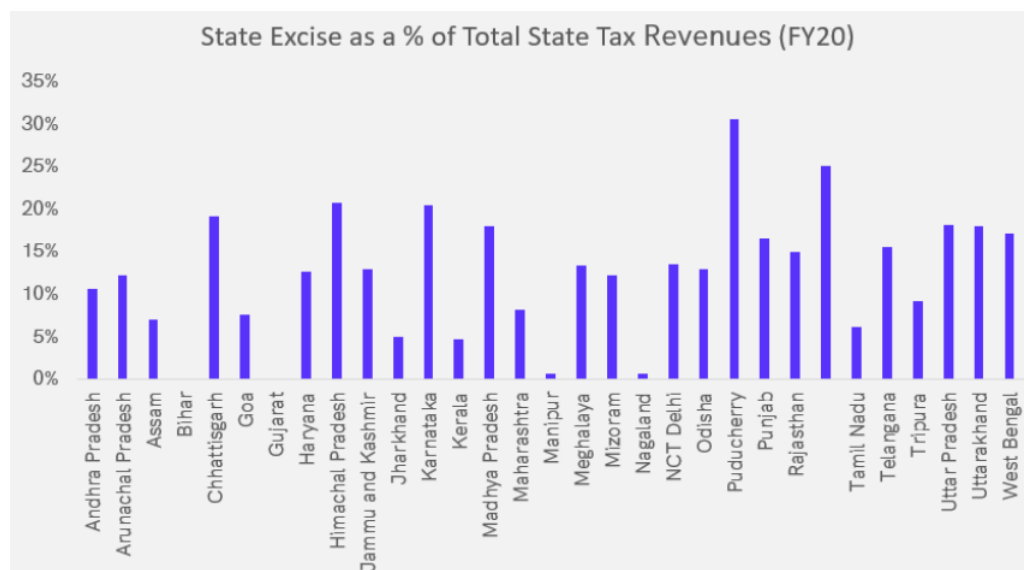
(Source – Technopak Analysis, Sula DRHP)

Given the extremely high regulation in the sector, supply chains in the alcohol industry are frequently subject to political control. Furthermore, control over distribution is just one aspect. States also regulate prices. The final price

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of alcohol, known as the Maximum Retail Price (MRP), is determined by various factors including the ex-distillery price (EDP), excise duty, and the profit margins of wholesalers and retailers.

The amount of excise duty varies depending on factors such as the type of alcohol, alcohol content, and state regulations. As one might expect, State Governments derive substantial benefits through excise duties.



Source – Government Websites, Media articles, Investec Research

While they aim to maximize their gains, they need to maintain a balance that supports the long-term sustainability of the alcohol business. They need to ensure that they don't get greedy and "kill the golden goose".

Bargaining power of suppliers

"Wait, so sugarcane can be used to make Whiskey?"

Given that close to 68% of all spirits consumed in India is whiskey (by value), let's use whiskey as an example when considering the bargaining power of suppliers in the alcohol industry. Whiskey production can be simplified into the following steps –

1. **Sourcing Raw Materials:** The process begins with sourcing the necessary raw materials, which typically include grains such as barley, corn, rye, or wheat.
2. **Malting:** The selected grains are soaked in water, allowed to germinate, and then dried using hot air. This process activates enzymes that convert starches into fermentable sugars.
3. **Mashing:** The malted grains are ground into a coarse powder called grist, which is then mixed with hot water in a mash. The mixture is stirred, allowing enzymes to break down the starches into sugars.
4. **Fermentation:** The resulting liquid, known as the mash, is transferred to fermentation vessels, usually large tanks. Yeast is added to the mash, triggering the fermentation process. Yeast consumes the sugars and converts them into alcohol, resulting in a liquid known as the wash.
5. **Distillation:** Distillation involves heating the wash and collecting the vapors that contain alcohol. These vapors are then cooled and condensed, resulting in a liquid with a higher alcohol content known as a distillate or new make spirit.
6. **Maturation:** The new make spirit is transferred to oak barrels for maturation. The whiskey ages in these barrels over a specified period, allowing it to develop flavor, aroma, and complexity.

7. **Blending (Optional):** In the case of blended whiskies, different batches of whiskey may be blended together to achieve a consistent flavour profile. Blending can involve whiskies from different distilleries or even different countries.
8. **Bottling:** Once the desired maturation period is reached, the whiskey is filtered, and it undergoes a bottling process. Hence, volatility in the prices of glass can impact margins.

Barley is the primary ingredient used in the production of whiskey. However, India's whiskey landscape also features a significant presence of whiskies made from molasses, a by-product of sugarcane processing. The bargaining power of suppliers differs according to the production process.

1. Whiskey Production with Direct Extra Neutral Alcohol (ENA) Procurement

In this approach, whiskey producers source Extra neutral alcohol (ENA) from suppliers and blend it with other ingredients and flavors to create their whiskey products. The availability of ENA play a crucial role in determining the final taste and character of the whiskey. Some Indian whiskey brands even incorporate whiskies sourced from outside India, such as Scottish whiskies, to enhance the complexity and depth of their blends. Larger companies with established networks and resources can leverage their scale to secure reliable supplies of whiskies from around the world.

2. Whiskey Production through Traditional Methods

A few Indian whiskey brands prioritize the use of barley as the main ingredient and adhere to traditional whiskey-making techniques. These companies distill their own whiskey from barley, often in a single malt style, and subsequently blend it with other whiskies to achieve the desired flavor profile. By controlling the production process and utilizing their own malted barley, these brands have greater control over the quality and character of their whiskies. However, this traditional method has a longer turnaround time and investment. Companies need to age their whiskeys made from barley for a minimum of 2-3 years (requires warehousing investment). Furthermore, given the weather conditions in India, the evaporation of whisky during the aging process is significantly higher compared to countries like Scotland. This phenomenon, known as the "angel's share," reduces the overall efficiency of whisky production.

The bargaining power of suppliers differs depending on the sourcing strategy and capabilities of each whiskey producer. Fluctuations in ENA availability and price, influenced by grain supply, government regulations (such as ethanol blending), and global commodity prices, can impact production and blending processes.

Competitive rivalry

"No spirits attached"

In a price-sensitive market like India, where there are 2-3 large players, pricing undoubtedly plays a significant role. However, one would be remiss not to recognize the importance of ensuring the availability of products to the end consumer.

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Source – News, Investec Research. (The FMCG Outlets are more than 10 million)

Companies understand the importance of supporting retail stores and outlets to enhance their brand visibility and capture consumer attention. They invest in tailored marketing initiatives, allocating resources based on the prominence and reach of each retail establishment. By collaborating with retailers, they create a strong presence on shelves and in displays.

Moreover, these players recognize the significance of on-premise consumption in shaping consumer preferences. They actively engage with the hospitality sector, forming exclusive partnerships with restaurants, bars, and pubs.

To foster brand loyalty and further establish their presence, companies organize cocktail making workshops, collaborate with talented bartenders, and curate unique experiences for consumers. By offering these interactive events and initiatives, they aim to deepen customer engagement and showcase the versatility and quality of their products.

Overall, in the competitive rivalry of the Indian alcohol industry, companies focus not only on pricing and branding but also on strategic collaborations, experiential marketing, and exclusive partnerships.

Conclusion

Threat from new entrants	Threat from substitutes	Bargaining power of buyer	Bargaining power of supplier	Competitive Rivalry
Low	Low	Very High	Neutral to High	Neutral to High

To conclude, if a friend comes up to me one day and says, “Hey, I’m thinking about starting a business. I need a bit of capital and a government approval. The government will be controlling my pricing. Oh, and I will have to pay a fee to the government just to do business, apart from taxes. I can’t directly advertise my product, and yeah, I’ll be competing with giants.”

Well, let’s just say my eyebrows would shoot up as I’d reply, “Oh boy, you sure know how to pick a challenge!”

This article was co-authored by Dhruv Maniyar and Mehul Jani.

Sources & References

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8. Source: WHO, Global Health Observatory (GHO), Our World in Data

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