

GST and its Impact on FMCG



Fast-moving consumer goods (FMCG) are products that are sold quickly and at relatively low cost. Examples include non-durable goods such as packaged foods, beverages, toiletries, over-the-counter drugs and many other consumables. It is clearly evident that all households are thus affected with any change in the pricing of these items. GST (Goods and Services Tax), which has replaced a plethora of taxes, has led to change in cost as well as distribution strategy of FMCG companies. This has in turn led to change in pricing /quantum per pack. This article aims at explaining the same.



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Goods and Services Tax (GST) implementation is one of the biggest tax reforms in India since independence. The current tax structure is very complex and differs from state to state. The evolution of GST can be seen as a gradual transformation of a disparate, complex and cascading tax structure into a largely unified value added system of taxation. The

current tax structure can be classified into three categories:

- **Central indirect tax:** Custom duty, Central excise duty, Central service tax etc.
- **State indirect tax:** Value added tax (VAT), entry tax, luxury tax, entertainment tax etc.
- **Local tax:** Octroi and other entry tax

Highlights of the GST tax structure are:

- **Dual GST** for centre and states, Integrated GST (IGST) on interstate transactions
- **Free credit flow-** No cross credit for Central GST (CGST) & State GST (SGST)
- **Refund** of unutilised accumulated ITC (income tax credit)

The impact of current fiscal policies has been such that most companies had to give priority to tax benefits over operational efficiency. As an example, many companies have established warehouses in all states where they have a significant market size and transact on “stock transfer” as a way to nullify CST which is paid during interstate sales. Post GST, the very existence of many of these facilities has come into question.

GST regime has brought several benefits for the economy and has vitalised the fast-moving consumer goods (FMCG) industry.

While there are big players in the industry, a big share of the market is unorganised. GST is helping level the field.

However, the GST rate structure reflects not all FMCG companies stand to benefit from the new regime.

The rates for various FMCG segments have mostly been along expected lines. Items of mass consumption—toothpaste, soaps, hair oil have been put under the 18% tax slab, significantly lower than the pre-GST 22-24% tax rate. This is in accordance with the government’s stance of keeping tax rates low for mass consumption products. As a matter of fact, the GST rate schedule indicates that most of the items are in the 18% tax bracket or below. Only 50 items fall in the 28% tax slab.

Post GST, tax incidence for FMCG companies has come down and the companies have passed it on to the consumers in the form of lower prices or higher quantity for same price. This was also reinforced with the anti-profiteering clause in place.

Post GST, tax incidence for FMCG companies has come down and the companies have passed it on to the consumers in the form of lower prices or higher quantity for same price. This was also reinforced with the anti-profiteering clause in place. Lower prices have potentially supported volume growth for certain products, particularly in the rural segment.

Positively Impacted Firms

In order to analyse which companies have benefitted from the new tax regime, point of relevance is their product mix. Oral care major Colgate Palmolive has likely emerged as the biggest beneficiary. “Colgate pays an effective tax of 25-26%. The new 18% tax on toothpastes (make up 80% of the company’s sales) is a positive, particularly as it levels the playing field against Dabur and Patanjali, who enjoy tax benefits,” said a Motilal Oswal report. Hair and edible oil companies have also benefitted. “Marginally lower rates in hair oil with no increase in edible oil rates will benefit Marico,” said an Axis Capital report.

Adversely Impacted Firms

Some of the products that had earlier been placed in 28% category have now been moved to 18% in Nov. '17. “Higher tax rate in paints and possibly baby food will marginally impact Asian Paints and Nestle,” said an Axis Capital report pre-changes. Higher tax rate for detergents (i.e. powder format) and shampoo was a real dampener since these are daily-use, mass consumption items. But, the rationalisation in Nov. '17 has brought these items into 18% criteria.

Having said that, it is not expected to have much impact on the sale volumes. Most items belonging to premium category have been put under the highest tax slab of 28%. But this is not going to have a particularly negative impact on manufacturers as they have been paying similar taxes earlier. The increase, in many cases, is marginal.

As mentioned earlier, product mix would play a vital role in deciding whether the company benefits or is adversely impacted in GST scenario. Firms who were earlier focusing on premiumisation of their product mix to drive profitability, could be hurt because of the higher taxes. These firms will have to rethink strategy and realign their portfolio. Ayurvedic products- a segment that is seeing increased focus from leading FMCG players are taxed at 12% GST, slightly higher than the prevailing rate. This has hurt Dabur, which has a wide portfolio of ayurvedic products. Emami too has felt the jolt.

In FMCG sector, substantial savings can be generated by companies in logistics and distribution costs as GST will eliminate the need for multiple sales depots. As any supply (sale or stock transfer) would be treated taxable under GST, it may lead to increased requirement of working capital and cash flow to be effected till claims gets settled.

Ayurvedic players were expecting the tax rate to go down, given the government's thrust on popularising traditional Indian medicine.

For most FMCG majors, GST rate structure is mostly neutral or marginally positive, as their broad portfolios have seen a mixed impact. For instance, in case of HUL, tax incidence has reduced for soap, toothpaste and tea, but increased for detergent, shampoo and skin care. For Godrej Consumer Products, lower tax incidence on soaps and insecticides is a positive, but higher tax rate for hair dye is a dampener.

Impact on Distribution Strategy

The supply chain network of a company is seldom optimal. Reasons for the same can often be associated with the major changes happening in internal and external environments such as demand pattern, tax policies, introduction of new products, suppliers and competitors actions, etc. which are inherently dynamic in nature. When one or more of these factors change, the network is often rendered sub-optimal. Since re-designing the network involves significant effort and cost for the company, it cannot be done for every small change which occurs. But it is imperative to carry out this activity when a major change occurs in any of the factors. One such change is the proposed introduction of GST in India which has rationalised the current, complex tax structure.

Two aspects of GST hold special significance from supply chain perspective:

- **Elimination of Central Sales Tax (CST)** for interstate movement of goods
- **Uniform taxes** in most parts of the country

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effected till claims gets settled. For manufacturers, who have established their units in areas having tax holidays or incentives (like Himachal, Uttaranchal, etc.), might not enjoy the same benefit post GST. FMCG distributors and retailers will be benefited as they will be able to set-off input credit from services (say transport, rent, etc.) against their GST liability, which is currently not possible. The key beneficiaries of GST are Hindustan Unilever, Colgate, GSK, Asian Paints.

The structure of supply chain is influenced by differential taxes based on geographical location. By eliminating multiple state taxes, companies are encouraged to consolidate their warehouses instead of maintaining one in each state to avoid Central Sales Tax (CST). This in effect brings the overall cost of the product down as the inventory cost and inventory carrying cost down. This directly affects the final cost of the product and brings down the selling price. The cost saved by the companies as a result of GST can be used to invest further to improve serviceability. Post GST implementation, design of supply chain is to be based on customer service and logistics cost. It also offers flexibility into demand and supply matching. GST has also enabled firms to increase accuracy of forecast.

Following are the benefits enjoyed by companies post implementation of GST:

- Interstate sourcing of raw materials
- Price negotiation
- Improvement in quality
- Better forecasting
- Improved inventory management
- Better trade-off between cost and customer service
- Capacity expansion
- Greater flexibility in manufacturing

Impact on Warehousing

Location of a warehouse is generally chosen so as to minimise the cost of delivery for both the company and the customer. Other factors considered are access to arterial highways, ports, etc. for shipment and labour availability. The local state taxes are also a factor considered by companies before locating a warehouse. Some companies prefer to have warehouses in every state of the country to avoid local taxation while transporting from one location to another. With the implementation of GST, logistics companies can restructure their warehouse

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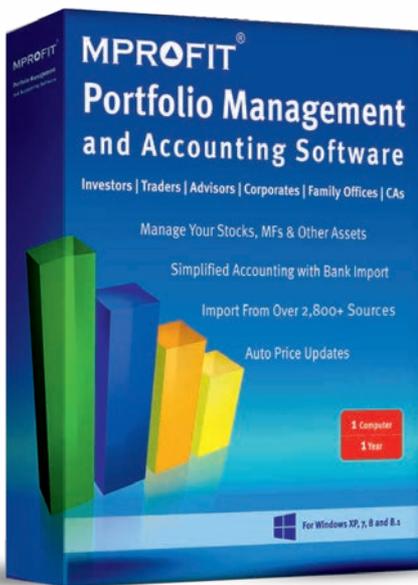
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Post GST application, FMCG players are expected to own or lease larger warehouses at prime locations such as Mumbai, Delhi, Ahmedabad, Chennai, Bengaluru and Hyderabad. As per analysts, smaller warehouses would be merged into bigger units at key locations with the aim of having higher efficiency.

locations and can have one central warehouse or can go for warehouses at specific locations or can adopt a hub and spoke (explained later in detail) model. With GST, the local state taxes are eliminated and there will be only one Goods and Services Tax across the entire country. This enables the companies to achieve cost efficiency in their operations and thereby transferring this cost benefit to the end consumer in the supply chain.

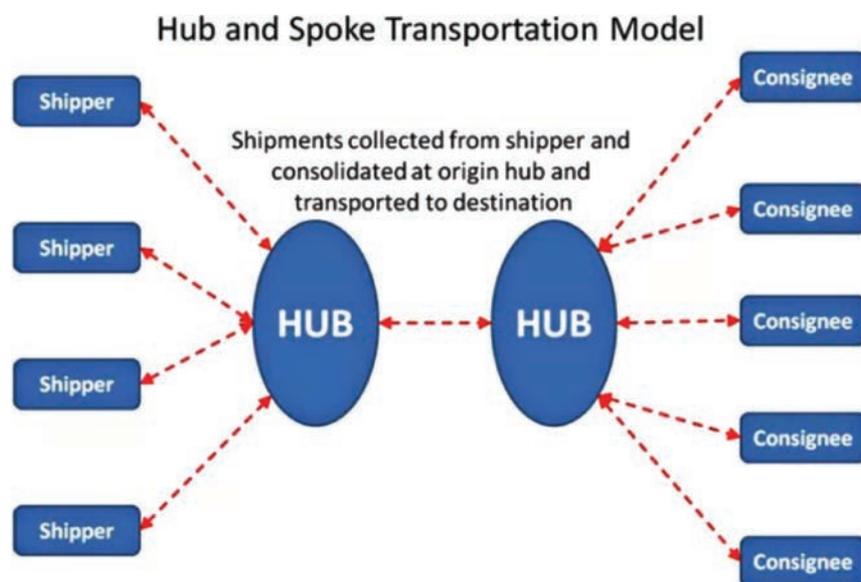
Currently, all states within the country levy tax on goods that are transported across borders at different rates. GST is a single tax on manufacture, sale, and consumption of goods and services throughout India. The objective is to have one indirect tax for India to make the country a unified common market. GST is collected at every stage of sale or purchase of goods or services, based on input tax credit method. This simplification of the taxation system has made inter-state transportation of goods more efficient. As higher than optimal time is consumed per transportation, logistics costs incurred in India are 2 to 3 times compared to the global benchmarks, according to the World Bank. In simple terms, the logistics cost in India is about 13 per cent of GDP as compared to about eight per cent in western countries and about 18 per cent in China. But with introduction of GST, India has become a seamless market without any difference between inter-state and intra-state sales. This has disrupted the existing ineptitude and facilitated structural re-engineering of the logistics network.

Service providers are incentivised to

leverage hub-and-spoke supply chain networks by operating large central warehouses and remodelling transportation routes. On the taxation front, at national level, it is resulting in more competent and efficient cross-state transportation, lesser paperwork for transporters, thereby reducing the logistics costs. Not just costs, it is also saving a lot of transportation time.

Industry estimates suggest that the logistics industry is expected to grow at a CAGR of 15-20 per cent over the next few years. It will enable faster and cheaper movement of goods across the country with a uniform taxation structure by reducing delays at the check posts and other entry points within and between the states. *Uniformity in rates* across States and elimination of Central Sales Tax is encouraging consolidation of warehouses along with elimination of smaller warehouses as supply chain systems are overhauled. There is a consolidation of smaller stock-transfer warehouses into large warehouses in major pockets of the country. Industry analysts anticipate that the largest warehouses will come up in the largest consumption centres of the country catering to more than 50 per cent of the country's needs. The rest of the country will be served from these large warehouses via secondary dispatch. Finally, the requirements for long distance trucks will increase due to consolidation of warehouses and long distance secondary dispatches.

Hub-and-Spoke Model





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The spoke-hub distribution model or network is a system of connections arranged like a wire wheel in which all traffic moves along spokes connected to the hub at the centre. The model is commonly used in industries like transport, telecommunications, freight, and distributed computing (where it is known as a star network).

The hub-and-spoke model, as compared to the point-to-point model, requires less routes. For a network of n nodes, only $n - 1$ routes are necessary to connect all nodes so the upper bound is $n - 1$. For example, in a system with 10 destinations, the spoke-hub system requires only 9 routes to connect all destinations, and a true point-to-point system would require 45 routes. The small number of routes may also lead to more efficient use of transportation resources.

Complicated operations, such as package sorting and accounting, can be carried out at the hub rather than at every node, and this leads to economies of scale. As a result of this, spokes are simpler to operate and new routes can easily be created.

Demand for larger warehouses will go up. Post GST application, FMCG players are expected to own or lease larger warehouses at prime locations such as Mumbai, Delhi, Ahmedabad, Chennai, Bengaluru and Hyderabad.

As per analysts, smaller warehouses would be merged into bigger units at key locations with the aim of having higher efficiency. Warehouses in smaller cities will become idle or defunct through this process and these are likely to be converted for residential or commercial use.

Impact on Consumer Spends

"The last few months have been subdued on account of demonetisation and GST. Companies are looking to offset the impact by pushing consumer promotions. The revival of rural consumption and good monsoon are the other factors why we are hopeful of a good festive season this year—hence spends will increase incrementally," says an industry expert. The festive season—typically October to December—accounts for 40% of annual ad industry revenue across sectors. Companies are expected to roll out new products and step up consumer promotions in December quarter. As per a recent report by Edelweiss Securities, advertising and consumer promotion spends will rebound in December quarter, with 15% year-on-year growth. "This turnaround is likely on the back of new launches

FMCG companies are likely to benefit in GST scenario. The bigger benefit accrues from the re-distribution strategy being adopted by big players in the industry. This will take time to reflect results as it involves multiple stakeholders and change in mind-set, but is definitely going to reduce costs and improve operational efficacy.



which had been deferred due to the destocking in Q1FY18," the report said.

FMCG continues to be the highest spender for advertising companies with a 32% share of total ad expenditure. Analysts said GST led to FMCG ad spends shrinking 20-25% in July.

Conclusion

Implementation of GST saw large companies reporting sluggish growth numbers for June quarter, hit by de-stocking on the part of channel partners ahead of GST taking effect. However, as per the above analysis, FMCG companies are likely to benefit in GST scenario. The bigger benefit accrues from the re-distribution strategy being adopted by big players in the industry. This will take time to reflect results as it involves multiple stakeholders and change in mindset, but is definitely going to reduce costs and improve operational efficacy. It is the consumer who ultimately benefits from the above. The companies have to gear up for making best use of the opportunities to remain competitive and improve margins by realigning distribution strategy. ■