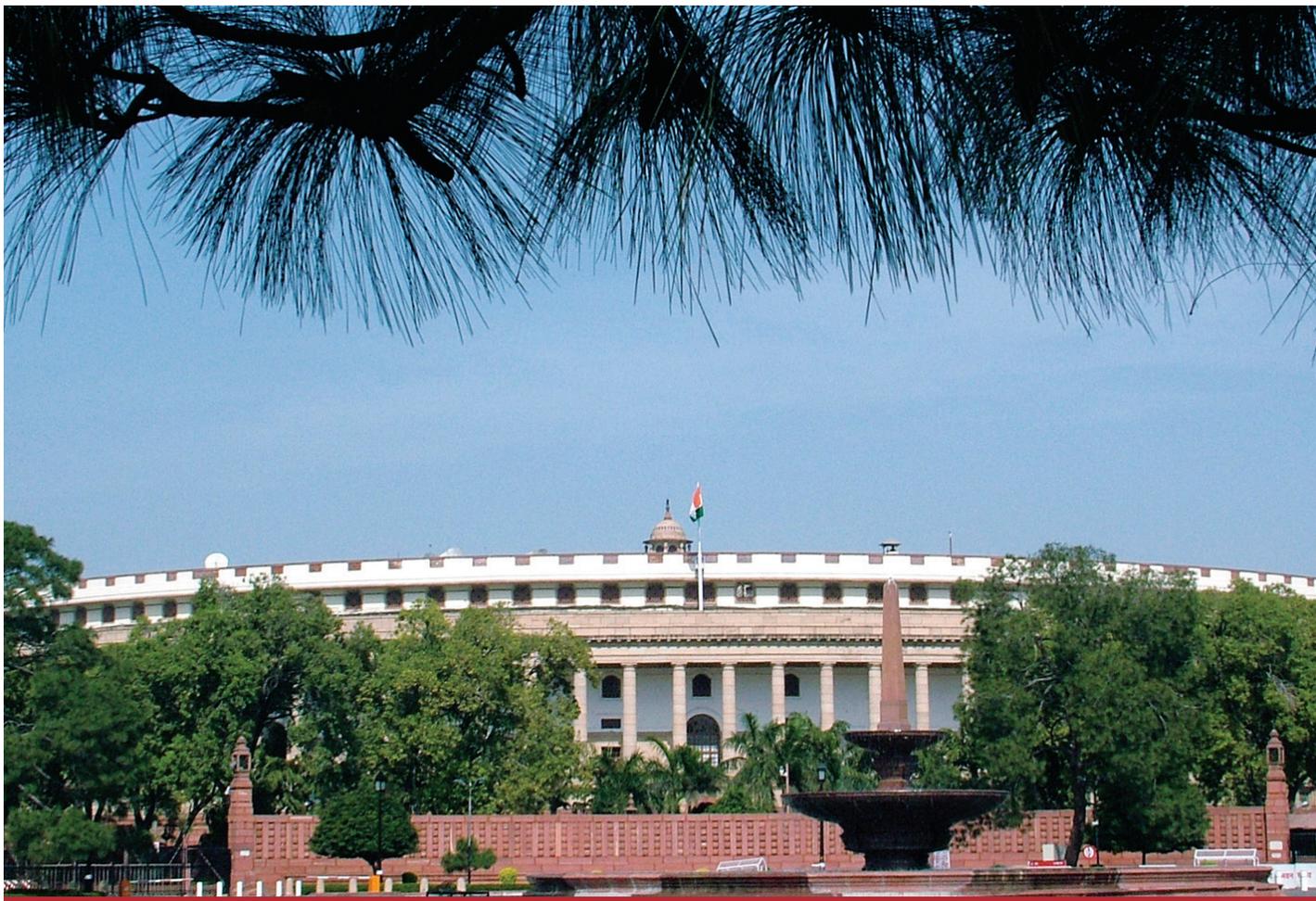


# Does India's New Government Mean Business?

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India is on the cusp of a new era after this spring's extraordinary election results. Prime Minister Narendra Modi and the conservative Bharatiya Janata Party (BJP) won landslide victories, giving BJP an absolute majority in India's parliament. This majority marks a historic paradigm shift in India. For the last three decades, various political coalitions have been regularly locked in power struggles that have dramatically stunted economic growth and hamstrung foreign investment, especially in the past few years.

The prospect of a pro-business leader has been welcome news to investors. Foreign investors optimistically poured more than 16 billion into Indian stocks and bonds in the past six months. Even Walmart, whose struggles in the country have been well publicized, announced it will open 50 new wholesale stores to support its e-commerce operations.

Reenergized investors notwithstanding, the reality is that in the near-term, India will continue to be a complex environment for foreign direct investment. However, there are substantial opportunities for companies that are able to negotiate these challenges. We asked Managing Director **Reshmi Khurana**, head of Kroll's India operations, and Senior Director **Probal DasGupta**, based in Mumbai, to put these recent developments into context in terms of both potential new opportunities and the risks companies need to overcome.

### Q: What do these election results mean for the country?

**RK:** India's investment slowdown — newly announced projects plummeted from 10 percent of the GDP in 2006-07 to less than 1 percent of the GDP in 2013 — which resulted in the decline in growth has been attributed to the problems inherent in coalition governments. That is, a complex regulatory environment combined with policy paralysis and populist state-level agendas. A stable government is expected to be better able to drive the reform agenda necessary for reversing the investment drop-off of the last few years.

**PD:** India has a tremendous economic engine in its youthful demographics — 65 percent of its population is under the age of 35. That's a working population of over 500 million people, similar to China in the early 1980s when its economy really took off. If India can accelerate growth now and put this population to productive work (preferably in the organized sector), the country can leverage this demographic dividend before the 2020s when it wanes away. So, from a demographics standpoint, the next five years will be critical for determining if India can reap the potential benefits of this workforce and the direction that the country will take.

### Q: How can foreign direct investment (FDI) play a role in reviving the India growth story?

**RK:** India's economic growth slowed to a decade's low of 4.5 percent in 2012-13. The country needs FDI to help regain its growth momentum. The government needs to plan for \$1 trillion in infrastructure spending in the five years through to 2017, and a portion of it will have to come through FDI. However, according to data from the Department of Industrial Policy and Promotion, FDI into India grew by a meager 1.5 percent to \$2.18 billion in January. So kick-starting FDI should be a key priority for the new government.

### Q: What do the elections mean for the foreign investor? Is there cause for optimism?

**PD:** The center-right BJP (and the National Democratic Alliance (NDA), the broader coalition led by BJP) is expected to drive a pro-business policy agenda. Once the government further stabilizes macroeconomic indicators (e.g., the rupee, current account deficit, and inflation), it will have created a platform for renewed growth, which as Reshmi pointed out, will require foreign investment.

**RK:** In its 42-page manifesto, the BJP said it would allow FDI across sectors wherever needed for job and asset creation—infrastructure development, and the acquisition of niche technology and specialized expertise. With a majority party now in control of India's parliament, the law-making body, resolutions are likely to get passed quicker. On the other hand, investor optimism should be tempered by the fact that businesses will continue to face challenges when operating in a complex environment such as India.

### Q: Which sectors or industries do you expect to draw the most FDI in India?

**RK:** I believe over the next two years we will see FDI focused in four areas: 1) infrastructure; (2) manufacturing; (3) retail; and (4) mining, energy and power. The priorities of introducing them could depend upon policy changes and political compulsions.

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**Q: Let's take one at a time and start with infrastructure. What has been the state of infrastructure in India, and what kind of opportunities await and what risks hinder investors?**

**RK:** In the World Economic Forum's most recent Global Competitiveness Report, India ranked 85 out of 148 for its infrastructure. So there is much work to be done; the good news is that the BJP has said that infrastructure will be among the priorities. The government might likely begin with low-hanging fruit, which includes fast-tracking approval for 125 projects worth \$64 billion previously stalled by the former government. Modi himself has stated that his focus will be on highways, ports and power; for example, he has said that a BJP-led government will revive the National Highway Development program.

**CASE STUDY:** An international manufacturing company was considering operating in a politically high-risk area in eastern India. It engaged Kroll to fully understand the risks of operating in the environment.

Kroll not only visited the region, it also engaged with local experts who were knowledgeable of the military and security forces currently deployed in the region. As a result, the team was able to obtain an on-the-ground view of the issues at the proposed factory site and engage with local stakeholders in order to get a tactical understanding of the risks of operating in the environment. Simultaneously, Kroll was able to help the client develop a view on the government policy in the region to determine long-term aims and objectives in the region, and likely political and security difficulties that a manufacturing company would face in the region.

Kroll produced a highly detailed report focusing on the political and security stability and long-term prognosis for the region as well as the views of stakeholder groups, likely flashpoints and helpful interlocutors.

**PD:** Additionally, projects such as the Mumbai-Delhi industrial corridor could help kick off subsequent projects. Around 76 percent of the corridor is located across the states of Gujarat and Rajasthan, which might mean fewer operational issues to contend with because ruling governments in both states are led by the BJP. In the past, most of the FDI-related projects got delayed due to political squabbles at the implementation stage.

**Q: Next, what do you see in store for the manufacturing sector? We talked earlier about the large, young workforce in India. Do you think this will play a role in promoting or supporting FDI in manufacturing?**

**PD:** Absolutely, manufacturing is a prime area where the demographic dividend can be better leveraged through the generation of jobs. And the manufacturing sector is ripe for development because it has been hit the hardest in the last few years. Projects worth 3.2 trillion rupees have been put on hold, the highest figure in almost two decades, according to data from the Centre for Monitoring the Indian Economy, an economic data provider. The policymaking focus could include rolling out implementation of the 2011 National Manufacturing Policy. The policy laid out plans to boost the manufacturing sector by raising its contribution to GDP to 25 percent and creating 100 million new jobs by 2025.

Given the government's announced focus on infrastructure, manufacturing is a logical adjacency that should benefit as well. Observers expect the government to create a more transparent taxation regime and to also simplify procedures. This should encourage investments in infrastructure, which in turn will encourage FDI in the manufacturing sector.

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**RK:** One caveat is that although investors face fewer regulatory and environment issues in setting up manufacturing facilities (compared to mining and power sector), they can expect headaches with labour and land acquisition.

**CASE STUDY:** A global commodities company with operations across India was asked to make political contributions to local unions backed by certain political parties. Failing to make the political contribution to the unions, the company was threatened with violent disruption of its operations by its subcontractors, who were members of the union.

Through discreet inquiries, Kroll investigated the strength and imminent action plans of the unions. The client shared the intelligence with law enforcement agencies, and any planned disruption was avoided. The union was ultimately penalized because of these threats.

Kroll helped the client avoid violating its global compliance norms and at the same time, avoid disruption of its business. While the client was initially contemplating closing its India operations, as a result of this investigation it not only eliminated this union from its operations, but also communicated a strong message to local politicians that it would not make any political contributions.

**Q. Retail is a sector that has generated much speculation in the business press. What is the new government's position on FDI in the retail space? Should investors take the possible FDI retail policy reversal seriously?**

**RK:** First, we need to keep in mind why retail is so important in India. The retail market, currently estimated at \$490 billion, is poised to almost double to \$865 billion in 10 short years. Therefore, one can understand why a great deal of uncertainty and angst was created when the BJP stated in its manifesto that it was opposed to the previous government's policy allowing FDI in supermarkets. However, Modi has indicated in a recent interview that there may not be a reversal in policy after all. In the short-term, it might be the case where they will let the matter rest in cold storage for a while, on an optimistic note.

That being said, I believe that while the government is unlikely to promote multi-brand retail FDI in the first six months, it may change its stance once it sees the impact of FDI in the infrastructure and manufacturing sectors.

**PD:** In the meantime, large companies might need to invest in the supply and distribution chain to promote future efficiencies. Looking at the issue from a different perspective, we might see FDI come into play through the backdoor as it were, i.e., channels where knowledge and expertise are transferred.

**Q: Finally, we come to mining, energy and power. What is the current state of FDI in these sectors, and again, what might foreign investors expect from the new government?**

**PD:** Almost half of India's energy requirements are subsidized. Hence, there is likely to be a comprehensive energy policy to harness oil, gas, solar, coal and nuclear energy. In many cases, however, one can't talk about energy and natural resources without taking into account the role that infrastructure development will play.

For example, the impact of last year's drop in iron ore production on local steel producers would have been higher but for a slowdown in the steel industry, which grew at 3 percent. On the other hand, if the government emphasizes infrastructure growth, there is a likely to be an increase in steel requirements, which means that mining regulations will need to be addressed by the government soon. Infrastructure investment could lead to productivity gains from improved roads, electricity and ports, leading to investments in the power sector.

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**RK:** Investors should be aware that in the past, the mining industry has faced several issues relating to environmental clearances, government approvals and corruption scandals. Increased judicial scrutiny following corruption scandals in the allotment of mining blocks and environmental degradation caused by illegal mining have made matters worse.

The Mines and Minerals (Development and Regulation) Bill 2011, which will replace a 1957 law, addresses some of these issues, but the Lok Sabha (the lower house of parliament) has yet to pass it. This law should encourage commercial mining, address environment issues and bring in technology.

One of the possible solutions that the government might adopt is to bring the several ministries of power, coal and oil under one umbrella of a "super energy" ministry, which could help decision-making and governance. The BJP has often spoken about "less government and more governance," and this is a ministry that needs such an approach. For instance, coal and gas serve the same purpose of producing power, and therefore it would be prudent to have one regulatory authority and one ministry for smoother decision-making.

**Q. You earlier alluded to the challenges of doing business in a complex environment such as India. Will the election of this pro-business leader and party change this environment?**

**RK:** Though policy changes take place at the level of the central government, the operational challenges of doing business remain. In fact, as the opportunities for investment improve, the complexity of doing business will increase. Even more problematic for investors is that heavier investment traffic is likely to put pressure on the current semi-efficient system with incomplete public information, a sluggish judicial mechanism, opaque disclosures, and high public and corporate corruption.

**Q. You've touched on some specific challenges in doing business in India. For those companies with fraud and corruption concerns, especially as they relate to the U.S. Foreign Corrupt Practices Act or UK Bribery Act, what would you say are the key risks in India today for investors evaluating opportunities?**

**RK:** When investing in India, companies should understand that commerce here is intertwined with the bureaucratic and political landscape. So Indian businesses do get pushed to adopt less than ethical practices. What gets recorded in terms of business practices and performance is often not the same as the actual performance of the business. Accounting and auditing standards in the country are also still evolving. The result is a relatively weak corporate governance environment and lack of sufficient transparency in financial reporting.

**PD:** India's relatively complex and slow-moving judicial and regulatory systems also pose a challenge because when investors face "bad faith" practices from local partners or management, they cannot rely on Indian courts to resolve disputes or hold errant counterparties accountable for their wrongdoing.

**RK:** All that said, corporate governance in India is evolving in a positive way. There is a new generation of entrepreneurs who have been rewarded by investors for following good governance practices. It remains to be seen if they can resist the pressures of the environment once they grow to a certain scale. But considering the pressure to improve governance and the greater activism shown recently by local regulators like SEBI, I think the future looks promising.

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## Q. In light of this environment, how should foreign investors approach their current or planned investments in India?

**PD:** Apart from the business model, we advise investors to focus on the following factors when evaluating business opportunities in India:

- Good quality entrepreneurs who are ethical and have a track record of good corporate governance
- The right management that can drive the vision of the entrepreneurs
- Good accounting systems that ensure transparency of financial reporting
- Understanding all open and hidden political linkages of the entrepreneur

**RK:** At the end of the day, the significant opportunity that India presents to foreign investors outweighs the risks described above. But investors need to be better prepared and understand all the dynamics of the Indian environment in order to maximize this opportunity and make investments with confidence.

**CASE STUDY:** An international manufacturing company in India had recently acquired an Indian company in a region unfamiliar to the new European owners. The new owners quickly discovered that a number of entities in the region were working against their interests. Local NGOs, unions, media and other pressure groups were actively trying to damage the international company.

Kroll investigated all aspects of the local geography and society where the acquisition was based. This included having people on the ground talking to local government officials, discussions with competitors, engaging with academics with a deep knowledge of the area, and discreet inquiries.

Pulling together all the strands of information, Kroll identified and categorized friendly and unfriendly stakeholders that enabled the client to target its corporate communications policy effectively and reduce its risks.

Before committing to major financial and resource undertakings in India, investors should obtain access to as much good quality and independent information as possible on their target partners and markets. They should infuse rigor and ruthless independence in their due diligence process. We believe this differentiates the winners from the rest in this difficult environment.

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**"It's imperative that before committing to major financial and resource-heavy undertakings, an investor should engage due diligence providers on a "no compromise basis" to ensure they are independent and that the integrity of the due diligence process is maintained."**

## About the Authors

**Reshmi Khurana**, Managing Director and Head of Kroll's India office. Reshmi has more than 14 years of experience in the U.S., South Asia and South East Asia conducting complex corruption investigations, litigation support and due diligence on the management, operations and business models of organizations. Her clients include asset management companies, corporations in the mining, oil and gas industries, consumer packaged goods, pharmaceutical industries and law firms.

**Probal DasGupta**, Senior Director, India. Probal has worked in South Asia and the U.S., advising firms on investment risks, business intelligence, investigations, and political and operational risks. He has worked on projects in infrastructure, manufacturing, steel, power, mining, and oil and gas sectors in different regions in South Asia. Probal served in the Indian Army for 10 years before transitioning to the private sector.

## About Kroll

Kroll is the leading global provider of risk solutions. For over 40 years, Kroll has helped clients make confident risk management decisions about people, assets, operations, and security through a wide range of investigations, due diligence and compliance, cyber security, physical and operational security, and data and information management services. Headquartered in New York with more than 55 offices across 26 countries, Kroll has a multidisciplinary team of nearly 2,300 employees and serves a global clientele of law firms, financial institutions, corporations, non-profit institutions, government agencies, and individuals.

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