Modified – Will India Shine Again?

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The May 2014 Indian general election was the largest event of its kind in history

814 million people were eligible to vote and 100 million of them were first-time voters[1]. It produced an exceptional result – something that very few had predicted but many had hoped for – the first single-party majority in over 30 years

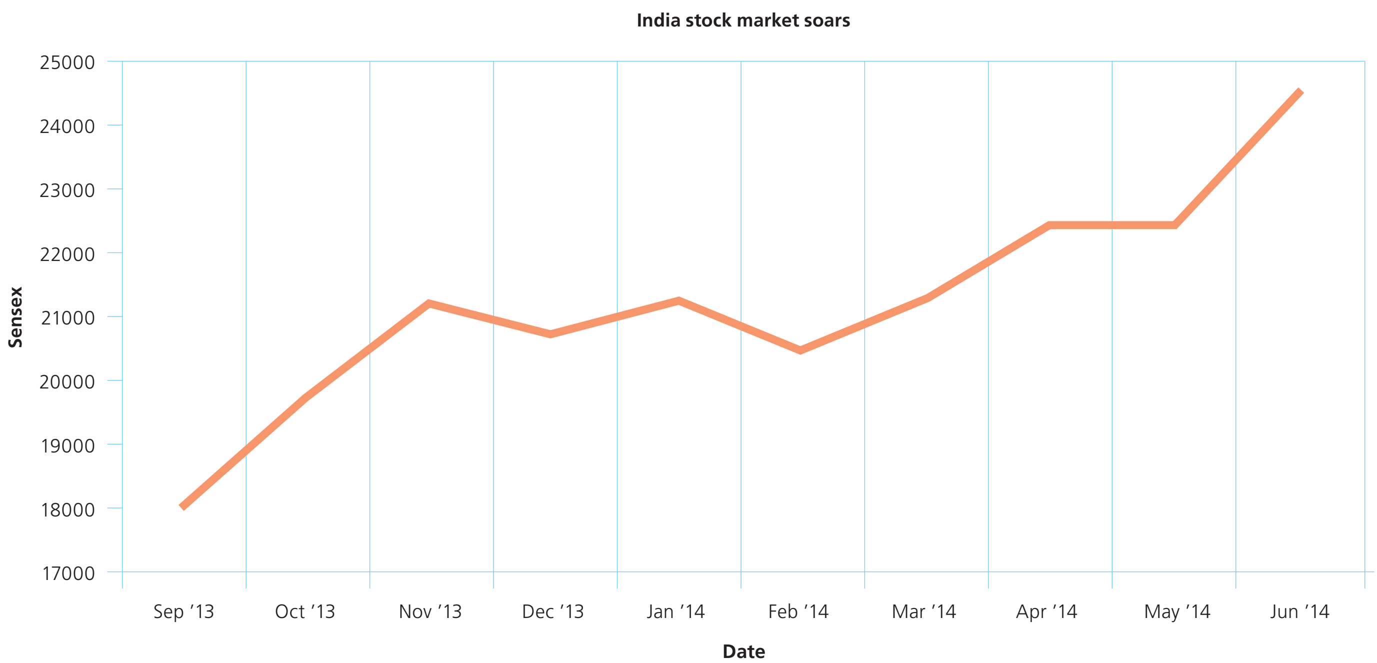
So, why is this big news?

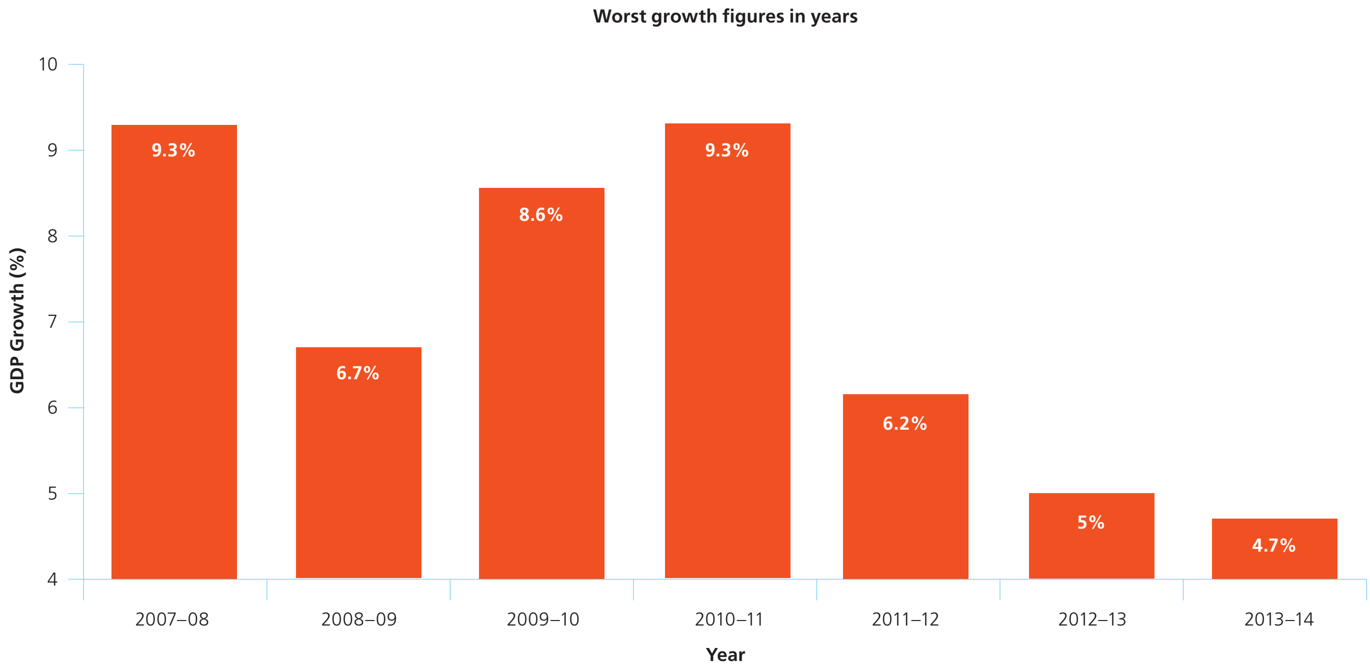
Indian voters have typically cast their vote on the basis of region, language, religion or caste. Weak coalition governments have been the norm and are cited as one of the key reasons for the country's slow progress. It seemed a perpetual stalemate – until this May. For the electorate to unite behind a single agenda was a truly exceptional moment. What happened to shift the balance of power? Commentators are attributing it to two main factors:

- **Anti-incumbency** – Even many traditional Congress voters felt that the Congress-led coalition had squandered India's growth and development opportunities and the country's international reputation along with it.
- **A 'vote for hope'** – Personified in (now Prime Minister) Mr Narendra Modi, the business-friendly, dynamic, former 'chai wallah' (Chief Minister) of Gujarat stood and won on a ticket of 'vikas' or development.

As a result, the stock market has soared. Both Indian and foreign institutional investors alike now believe that, after this election result, the brakes are off and India will rebound.

Just look at the Indian share index. The Bombay Exchange, Sensex, rose steadily by 39% between August 2013 and June 2014 as the result began to look more likely. Over the last year, it has been one of the world's best-performing stock markets.





Confused messages

In the same month that the Indian stock market hit record highs, the country posted its worst GDP growth in years and a second consecutive year of sub-5% growth[2], well down from the recent 9%–10% 'golden' years. And while those of you sitting in Tokyo or London may gasp jealously at 5%, much of that is agricultural growth and does nothing to add to the 10 million jobs per year needed to keep up with population growth. The real employer, manufacturing, actually contracted in 2013.

So why the sudden change of mood and the investor exuberance? Surely it is much too soon for any real change to have happened. Commentators put it down to two key reasons:

- **The 'Modi Wave'** – It was a vote for one man who represented one message: development. It was more like a presidential race than a vote for a party. Narendra Modi is a proven leader with a strong reputation for economic development, albeit at state level. Since he became the Chief Minister of Gujarat State in 2001 (population 63m)[3], Mr Modi has presided over a much-vaunted development programme, the 'Gujarat Model for Development', in his 12 years of continuous rule in Gujarat. Industrial and infrastructure development has accelerated. Bureaucracy and corruption has been reduced with Modi's philosophy of 'governance, not government' and it is widely regarded as the state to do business with. Gujarat has become one of the most developed states of India and its per-capita income is almost 20% higher than that of the national average[4].

- **Clear mandate** – Many of India's solutions are obvious, but may not be popular. There is a desperate need to get away from populist subsidies and tax sops and a belief that a majority party can take the tough decisions without fear of coalition disintegration. To echo the thoughts of India's prominent business leader, Vineet Nayar: "the emphatic nature of the election victory has given Modi such a strong mandate, leading inevitably to better decision-making in government, and that in itself will drive the GDP growth".

Mr Modi's task has been compared to that of Margaret Thatcher's in 1979 when she inherited a country beset by power cuts, inflation and an economy being held to ransom by the unions. Indian banks are

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creaking with bad debt from stalled infrastructure projects, inflation is running at almost 10%, industrial production recorded negative growth for 2013/14 and Indian companies appear more keen to invest overseas than in India. In a country where 50% of the population is under 26 years of age[5], India needs to create 10 million new jobs per year or risk its 'demographic dividend' turning into a demographic disaster. Currently it is getting nowhere near that target.

"Skills, scale and speed"

Modi's new mantra, "skills, scale and speed", reflects this focus on job creation and economic growth. India is blessed with a great competitive advantage – a massive, low-cost, English-speaking workforce. It must make use of it before the age of automation diminishes the opportunity. But before that it needs the infrastructure to support manufacturing – supply chains, power generation, skills training and education.

Foreign investment will play a significant role in this, bringing much-needed capital, capability and technology. So, gone is the Gandhian/Nehruvian, post-independence mantra of self-reliance. India cannot afford that any more. The language of the Modi administration is that of free-market economics, competition and international engagement. Sectors and companies that directly or indirectly support this generation of large-scale employment are likely to be the big winners.

However, the international community will take some persuading. In 2013, as growth plummeted and the rupee nose-dived by 30%, Odgers Berndtson conducted a survey of FTSE 100 CEOs on their appetite for investment in India. Respondees were unanimous in their belief that the long-term 'India story' remained unchanged but many had deep concerns about red tape and corruption. The general concensus was that "India is fast blowing its chances". In the 2013 World Bank's 'Ease of Doing Business' Index, India slipped further in the rankings to a lowly 134 of the 189 nations ranked. This is marginally ahead of Ecuador, but not as good as Yemen or Bangladesh, and 24 places below Pakistan.

The importance of confidence

Change cannot be achieved overnight. However, the initial fuel to kick start the economy is confidence, and that has returned with gusto. Companies that have been holding back investment now appear to be hitting the accelerator. These are the developments to watch:

Action to improve business sentiment

- Economic reforms to improve ease of doing business
- Increase foreign direct investment limits in sectors that have job creation potential
- Action on preventing retrospective application changes to tax law
- Predictable, transparent and fair policy regime

10-year infrastructure revival plan

- Focus on modernisation and revamping of railways
- Network of freight corridors with specialised agri-rail linkages for perishable agricultural goods
- Time-bound national highway programme
- Low-cost airports to promote air connectivity to smaller towns
- Port-led model of development: rail and road connectivity to ports
- Action to increase power generation – building of power stations and supply chain of coal to stations improved

"If India can create stable business conditions that are not subject to whims, the world investment community will flock to India to invest."

Lord Paul Swaraj
Hindustan Times, June 2014

Revival of manufacturing

- Develop world-class manufacturing hubs, particularly along freight and industrial corridors
- Attract manufacturers across industrial, process, chemical and automotive sectors
- Provide tax breaks for exporters
- Simplified tax regime to improve flow of components and the establishment of plants and production

Sector developments to look out for

Automotive

- A major focus for the Modi government will be to establish India as an alternative to Chinese auto manufacturing. Nearly

Skills training and investment in education will be a priority

25% of the world's cars are produced in China compared to 5% in India. India can provide a large-scale, skilled, low-cost workforce for the next 25 years if it wills it

- The government is expected to implement the second-generation economic reforms like the Goods & Services Tax while expediting the implementation of critical infrastructure projects that are stalled

Consumer products and services, retail

- Global FMCG companies are already present in India, serving the massive domestic market. As manufacturing, supply chain, logistics and transportation improve, they are likely to use India as a manufacturing and product development hub for export to Asian markets

Defence

- India's defence procurement has underdelivered, leaving the Indian Armed Forces woefully underequipped and in need of access to modern defence systems. The government will increase the FDI allowance from 26% to 49%[6] in order to bring in much-needed foreign technology and have its defence equipment manufactured in India as an investment rather than another transaction that adds to the BOP deficit

Education

- 50% of India's population is below 26 years old[7]. This will only be an asset if training and education can be provided to make the workforce effective and attractive to investors. Skills training and investment in education will be a priority

Healthcare and life sciences

- The Indian public health system is only for those who cannot afford private healthcare. Private healthcare will be a major element of the middle-class consumer boom, from hospitals to primary healthcare and dentistry
- Foreign manufacturers of pharmaceutical and medical devices are already well invested in India with FDI at the 100% maximum level[8]

Energy and natural resources

- Consumer diesel and gas pricing will be de-regulated, making exploration and production activity economically viable. E+P will be promoted as a priority to remove Indian reliance on imports, particularly with increased uncertainty in the Middle East

Financial services

- To promote financial inclusion and make the sector competitive, RBI is expected to grant new banking licences
- FDI cap in the insurance sector will be raised from 26% to 49%[9]
- Demand for credit is expected to pick up as the economy improves

> "What India needs is shipbuilding, huge manufacturing hubs"
>
> **Vineet Nayar**
> *Mint*, 2 July 2014

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The big question… will be: "Is India worth it?"

Information, communication, technology

- Already a sector where Indian companies are world class and foreign companies recognise India as a base for world-class talent. It can provide growth and much needed foreign currency but not enough jobs
- In Telecom, raising of the FDI cap from 74% to 100%, industry consolidation, better realisation from tariff and an end to price wars are seen as positive trends
- BPO companies continue to move up the value chain into consulting, analytics and increasingly complex processes

Industrial

- Manufacturing to be a key provider of jobs. Currently accounting for only 15% of GDP, Modi has targeted raising this to 25%[10]
- Taxes and red tape for manufacturing to be rationalised and special economic zones to be improved. The Modi government will seek to attract large-scale manufacturers

Infrastructure

- Infrastructure to be prioritised as an enabler of manufacturing, exports and economic activity – Modi government is clearing delayed and stalled projects in road, rail, port, power generation
- In India, logistics accounts for 20% of final manufactured product cost against an Asian average of 5%[11]. Transportation costs need to be cut through better road, rail, port and air connectivity
- Rail – FDI in rail to rise to 100%. High speed rail to be developed[12]

Who will be the winners?

Few companies, bar the large FMCG players, have met their revenue expectations over the last decade. The country has confounded seasoned business leaders and frustrated the most-patient investors. CEOs may well be thinking "fool me once, shame on you – fool me twice, shame on me".

However, at least for now, the long-term potential of the market remains, albeit with the caveat that India may never be an easy place to do business. Companies that understand this, temper their expectations, invest wisely in local talent and ensure that they are in it for the long haul will be the winners. On the flip side, companies that set expectations too high, over-extend their growth and are complacent about conditions they cannot change will struggle.

The big question for international business leaders looking at the next decade of investment will be: "Is India worth it?" It is highly likely that Mr Modi will hold the answer.

Notes

1 China Daily Asia, Article: Indians wrap up marathon election (May 12, 2014)
2 The Times Of India, Article: GDP grows 4.7% in FY14, 4.6% in Q4 (May 31, 2014)
3 Census of India, Article: Gujarat's Population 2014
4 Business day, Article: Before hailing Modi-fication of India, consider the facts (July 01, 2014)
5 Standard Chartered Report: India in the Super-Cycle, p12 (May, 2011)
6 Live Mint, Article: Cabinet clears FDI proposals in railway infrastructure, defence (August 06, 2014)
7 Standard Chartered Report: India in the Super-Cycle, p12 (May, 2011)
8 The Economic Times, Article: 100% foreign direct investment regime in pharmaceutical sector (October 11, 2011)
9 Live Mint, Article: Cabinet approves 49% FDI in insurance (July 24, 2014)
10 The Economic Times, Article: Board set under Anand Sharma to boost manufacturing sector (June 04, 2012)
11 Deloitte Report: Logistics Sector Present situation and way forward, p13 (January 2012)
12 Business Standard, Article (August 08, 2014)

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