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Foreign Direct Investing > **INDIA**

Currying Favor Again with Foreign INVESTORS

Sources suggest a re-ranking of the world's largest economies is occurring, with China leading the pack, followed by America, India, and Japan.

By **B. Srinivas**

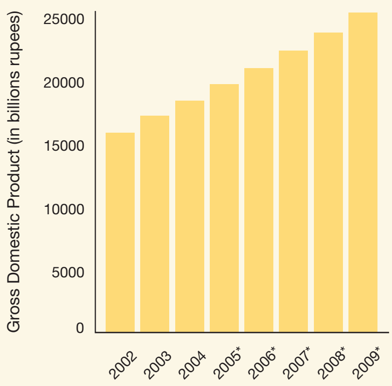
DURING THE LATE 1980s India relied increasingly on borrowing from foreign sources. This trend led to a balance of payments crisis in 1990, which began to infect every aspect of the Indian economy. GDP fell from 6.9% in 1989 to 4.9% the following year and down to 1.1% in 1991. That same year, inflation hit 17%. Pundits, forecasters, and economists all predicted doom for the Indian economy and its nearly one billion people. They were nearly right.

Fortunately a new government committed to economic reform came to power in June 1991. The new government allowed limited capital convertibility and began to throw off the socialistic impulses that prevented the Indian labor pool from fully demonstrating its prowess.

The pessimists may argue about the slow pace of Indian reforms, but the direction unquestionably has been clear and unambiguous. Growth during the 1990s was a moderate 5.6% to 6%, and has accelerated to 6% to 7% per year since the year 2000. Further acceleration is likely as excess capacity in the economy gets rapidly absorbed.

India has made headlines as one of the emerging economic global powerhouses. Offshoring of corporate services in the banking, financial, telecom, and IT sectors helped to push India's GDP growth over 7% in 2004. The country is now the

Blue Skies for GDP



SOURCE: Economy.com *Estimate

WILLIAM ALBERT ALLARD/GETTY IMAGES

TIGHT SQUEEZE *Office space demand is expected to reach 66 million square feet by 2007.*

AMIT BHARGAVA/CORBIS

A new government plan relies on FDI to transform India into a modern economy

1	**Infrastructure:** Attract more than US$150 billion within next 7-10 years to upgrade roads, airports, ports, hospitals.
2	**Power generation:** Attract US$85 billion over next 10 years to bridge current electricity generation shortfall.
3	**Housing:** Attract more than US$40 billion within a decade to create sufficient urban housing by 2015. There is an urban shortage of more than 12 million homes in 45 to 50 cities with a population of more than one million people each. This increases by approximately 1.5 million homes every year. Total demand for apartments in Bangalore is estimated at 24,000 units each year, with an expected annual growth rate of 20% over the next several years.
4	**Office Space:** Attract net investment of more than $1.5 billion each year to create 25 to 30 million square feet of new office space to meet increased demand from the IT and technology sectors. According to Cushman & Wakefield estimates, office space demand will reach 66 million square feet over the next three years. Over the next 10 years, an estimated 3 to 3.5 million jobs may be outsourced to India, with Bangalore the most likely destination.

fourth-largest global economy and second-largest emerging market economy, and has the world's second-largest English-speaking population. The country provides a cost-effective and extremely skilled labor base as well.

Some sources suggest a startling re-ranking of the world's largest economies is occurring, with China leading the pack, followed by America, India, and Japan, with Brazil and Russia following closely behind.

Unlimited Potential, Limited Capital

The government has recognized the opportunity, but there is a great chasm between India of today and the India of tomorrow. The government's plan is to double per-capita income at least once a decade. To do so, India would need to grow from 8% to 10% every year.

New Approach to Investing

In February 2005, the Indian government got the ball rolling by announcing landmark legislation allowing FDI into Indian real estate. Previously, it was limited to integrated townships and only on land parcels of 100 acres or more. Now, India allows 100% FDI in the construction sector. Land parcel minimum has been reduced to 25 acres, which has opened up more opportunities for international investors and developers.

This legislation is anticipated to inject more than US$1 billion annually into India's development and construction industry.

The Indian debt market also has rapidly matured and become increasingly buoyant. A robust secondary market for commercial real estate paper also is forming. It is estimated that more than 60% of the growth in mortgage lending was due to increased exposure of financial institutions to commercial real estate. In addition, India largely follows English law in practice and spirit, thus ensuring a great level of comfort to foreign investors.

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Offshoring Drives Hot Office Market

Offshoring continues to drive India's office market, and is expected to do so for the foreseeable future. Across the major cities in India, demand for new office space alone has grown from an estimated 3.5 million square feet in 1998 to nearly 16 million square feet in 2004. Approximately 14.5 million square feet of new office supply was added in 2004, with an additional 22 million square feet coming online by year-end 2005.

Yet the supply coming online cannot possibly meet the insatiable demand. Over the next three years, cumulative demand for office space is estimated to exceed 66 million square feet. Approximately 80% of this pan-India demand is expected to come from the IT and Business Process Outsourcing sectors. IT parks constitute a growing segment of the overall office property market with potential absorption of close to 43 million square feet from 2005 to 2008.

Sleeping Industrial Giant?

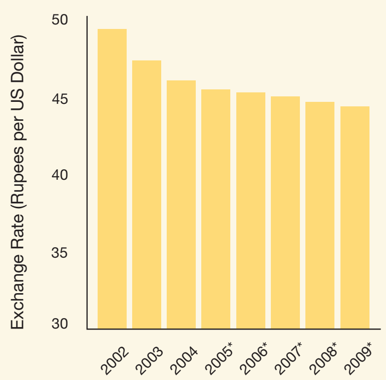
Unlike China, India is generally not known in the West for its industrial prowess. But it is known for raw material availability, an advantage that China lacks. That benefit may offer India a future as an export powerhouse.

Tata Group is one company attempting to exploit this advantage. One of India's oldest, largest, and most respected business conglomerates, Tata comprises 91 companies and employs 220,000 people in six continents. It has big plans to be a global exporter. One idea is development of a $2,200 passenger car that can be shipped in a kit and assembled at a point of sale. In

FDI in India remains "controlled," but the opportunities now available are immense.

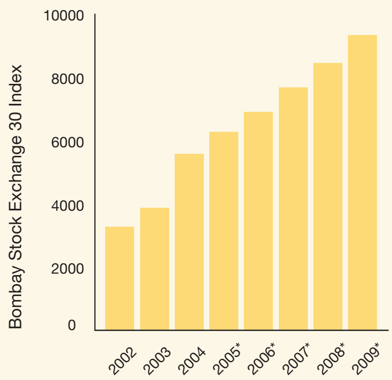
1	Non-resident Indian investments allowed under all categories.
2	Direct FDI allowed in residential townships of more than 25 acres, with minimum paid-up equity capital of US$10 million, and US$5 million if invested in a joint venture.
3	Direct and automatic approval for IT park and hotel investments.
4	FDI allowed in construction with approval from the Foreign Investment Promotion Board for projects offering build-up area of more than 3.5 million square feet.
5	Foreign and domestic venture capital investment in real estate allowed with prior approval of Securities & Exchange Board of India.
6	Dividends can be freely repatriated; three-year lock-in for equity repatriation.
7	Within special economic zones (akin to foreign trade zones in the USA) free capital and dividends allowed with many specific tax exemptions on profits (5 to 10 years), and local taxes.
8	Foreign investors allowed investment positions in greenfield/brownfield developments.

A Stronger Rupee



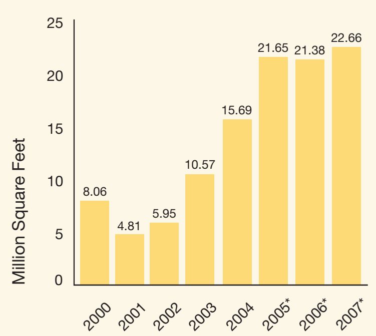
SOURCE: Economy.com *Estimate

Running with the Bulls



SOURCE: Economy.com *Estimate

Office Space Demand Forecast



SOURCE: CMG, Cushman & Wakefield, India *Estimate

September, Fiat S.p.A. and Tata Motors announced a plan to study cooperation in the area of passenger cars across markets, including development, manufacturing, sourcing, and distribution of products, aggregates, and components.

A genuine attempt by the government and its various agencies to create real and physical infrastructure, and incentives within the operational environment, has created a significant and yet unexploited potential for assembly operations. Current incentives could bring down the cost of production by more than 15%, thus boosting bottomlines by 7% to 8% in certain cases. The major incentives are related to taxes and other levies.

Apart from these explicit incentives, there are also possibilities to negotiate specific infrastructure support (with guaranteed performance) from the state governments, owing to severe competition among these states to attract investments and spur employment.

Risks, Hurdles Remain

In spite of the new legislation and growth in capital markets, investing in India remains filled with risks and hurdles for a foreign investor. Among them:

- Absence of title insurance and digitized land records.
- Corruption - plethora of regulations and non-transparent bureaucratic processes.
- Mortgage recourse often to promoters rather than pure project risks.
- Absence of hybrid financial structures.
- Undercapitalized developers and projects.
- Limited lease tenures—typically 9 to 10 years for commercial office space.
- Some retail tenancies can be up to 20 to 25 years, but typically an exception.

Most suburban areas, which present the vast majority of the investment opportunity to foreign investors, are newly developed, which means historic land title and regulations need thorough investigation. Typical areas for due diligence include nature of business conducted from premises, cost of tenant improvements, stability of the business historically, and lease price as benchmarked to market, vacancies, etc. Conversely, most new land supply in India is freehold in nature and government ownership/title of land is shrinking, though slowly.

Incentives: Manufacturing in India

Income tax incentives, usually:

- **100% for the first 5 years of operations**
- **25% to 50% for the second 5 years**
- **25% to 50% of the reinvested profits for the subsequent 5 years**

Other incentives related to local production tax and sales tax.

Other negotiable incentives.

Finding the Right Dance Partner

Once foreign investors understand the risk/reward tradeoffs, most decide to find a local partner who has access to clear land, adequate knowledge of local regulatory nuances, and the ability to run the gamut of project-level regulatory approvals.

The challenge of finding the right partner, both from a bankability and cultural-fit perspective is increasingly difficult. Local players want partners who can go beyond merely cutting checks. They want partners who can transfer better and more efficient construction technology and who have:

- better planning and design skills
- access to capital sources
- enhanced property and facility management know-how and processes
- international branding, and
- access to relevant customer markets and forums.

In the past four years, C&W India has assisted multinational clients in acquiring or establishing operations in more than 14 milllion square feet. Our thorough understanding of local practices and cultural nuances helps clients to forge local partnerships in India and rapidly extend relationships in the market.

First-Mover Advantage

If the 21st century belongs to Asia, India and China will certainly lead the way. The success of their economies is imperative—not only for their combined populations of more than 2.2 billion people, but also to ensure that the developed world at large remains cost competitive.

Given India's apparently insatiable need for funds to drive and sustain its nascent economic growth, further financial liberalization can be expected, including full capital convertibility and the introduction of mutual fund and REIT vehicles. For now, the current regulatory framework allows for a measured dose of foreign capital and seeks to prevent rampant speculation.

Over time, India as an investment destination will become better understood. Investors who have made an early entry, built a track record, and created goodwill should be able to cash in once stock positions and investor interest gathers momentum.

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