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Risk Advisory

Helping our clients evaluate, manage and mitigate risk

This edition of Risk Advisory is the first to focus exclusively on India. An increasing number of our clients are pursuing commercial opportunities in the region and our 28 March breakfast seminar on India was almost fully booked within hours of sending invitations. This newsletter will explore some of the key business developments, while also outlining some of the challenges that investors may face.

India's drive to become a great power has received wholehearted support from the US, in particular President Bush, who sees India as a democracy of significant strategic and economic importance. Against this backdrop, US private equity houses have flooded into the country spurred on by profitable early deals, such as Warburg Pincus' investment in Bharti Airtel. At the same time, Indian businesses are looking outside the country both to make acquisitions, as evidenced by Tata's acquisition of Corus, and to raise capital: in 2006, Indian companies raised upwards of £1.2 billion on AIM. With the Indian Ministry of Finance also considering allowing primary listings of Indian companies outside India, this number could increase significantly.

"... there is no doubt that everyone is looking closely at India."

For the reasons outlined above, there is no doubt that everyone is looking closely at India. However, investors do face risks which they will need to counter to succeed. One of these is that firms may have to pay a premium to establish a presence in India, as illustrated by Vodafone's recent acquisition of a stake in Hutch-Essar. Furthermore, those used to doing business in developed economies may find Indian regulations, for example those governing Special Economic Zones, to be unpredictable and difficult to navigate. Moreover, there is the ever-present threat of terrorism from groups including Islamic extremists, who appear to be increasingly interested in economic targets, particularly in the southern part of the country.

As ever, we hope you find these articles interesting and helpful in mitigating your risks when making investment decisions.

Bill Waite
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'Natural allies' re-discover each other

Ed Luce, former South Asia Bureau Chief, Financial Times

India's rise on the world stage has been heartily endorsed by the US, especially President George W Bush, whose strong belief that a democratic, pluralistic and entrepreneurial India is a 'natural' US ally has set the tone for his administration. As a result, the US is now India's largest partner for trade and investment, with bilateral trade valued at more than $26 billion, and still growing. In this piece, Ed Luce chronicles US-India relations since 2000 and explains how deepening political and commercial ties between the US and India have become a permanent feature.

When George W Bush was taking foreign policy lessons from his team of advisors (led by Condoleezza Rice) during the 2000 presidential campaign, the subject of India arose: 'A billion people and it's a democracy. Ain't that something?' said the then-governor of Texas.

"For the first time in US history, Washington has declared specifically it will sponsor another country's rise to 'great power' status ..."

What to some might have been a throwaway line about a faraway country was to Mr Bush an instinctive statement of support for a nation that Washington now routinely describes as a 'natural ally'. Despite its continuing prickliness over sovereignty and a residual sense of anti-Americanism, India has returned Mr Bush's overtures with interest.

The burgeoning US-India relationship reached an apogee last year when Mr Bush visited New Delhi for the first time and concluded an unprecedented deal that permits India to derive all the advantages of being a signatory to the nuclear Non-Proliferation Treaty (NPT) without actually joining it. In other words, Mr Bush signalled that the US attached greater importance to India's emergence as a civilian and military nuclear power – and thus implicitly endorses New Delhi's view of the NPT as a form of 'nuclear apartheid' – than it does to the principal mechanism for containing the spread of the world's chief weapon of mass destruction.

In diplomatic terms, what Mr Bush did amounts to a sharp course correction. When observers point to Mr Bush's tendency to follow his instincts, they highlight his administration's unquestioning support for Israel. They could just as persuasively point to the US-India nuclear deal.

It is true that many in both the US and India were outraged by the deal, which non-proliferation experts in Washington said would incentivise other non-signatories to acquire nuclear weapons and encourage existing ones, such as Iran, to persist with their clandestine programmes. And in India, Manmohan Singh's Congress Party-led coalition was assailed by the opposition Hindu nationalist BJP, which wishes it had concluded the deal so that it could take the credit, as well as by Mr Singh's allies in the communist bloc of parties, which – being pro-China and anti-American – take a somewhat nuanced view of the world. They oppose nuclear weapons for all countries (including India) but make an exception for China and Iran. However, neither set of domestic opponents were able to stop the deal. In spite of such objections, the bill was enacted by a margin of 85 to 12 in the US Senate last November – an extraordinary measure of the broad-based support India can now draw upon in Washington DC.

But the US-India relationship has larger significance still. For the first time in US history, Washington has declared specifically it will sponsor another country's rise to 'great power' status – a slightly antiquated phrase but a clear statement, nonetheless, of Mr Bush's aims.

There are three reasons to believe America's sponsorship of India will outlast Mr Bush's tenure in the White House. First, India is emerging rapidly as an economic powerhouse. It is true that Mr Singh's government has been unable to advance New Delhi's economic reform agenda very radically, partly because of the objections of the communist parties, whose Sinophilia does not apparently extend to China's economic record. But the limitations imposed by India's complex system of multi-party coalition matter less nowadays to the country's overall economic performance than they used to. In spite of achieving very little since he came to office, Mr Singh has happily pocketed annual growth rates of

George Bush and Manmohan Singh in 2006

eight per cent or more. Partly because of India's booming services sector and an increasingly competitive manufacturing export base, GDP growth rates between seven and eight per cent appear sustainable even in years where the annual monsoon fails. This is good news for American exporters, from whom the US State Department takes some of its cues.

Second, India is a frontline ally in what looks to be America's increasingly long-term battle with Islamist terrorist groups around the world. Many of the Pakistan-based groups that target Indian security forces in the contested province of Kashmir, and also civilians in cities like Mumbai and New Delhi, are linked to Al-Qaeda. Thankfully for those who cherish India's system of secular democracy, the increasingly fratricidal opposition BJP has been unable to capitalise on Mr Singh's weaknesses in government. But to an America that takes an increasingly Huntingtonian view of the world, the BJP's return to power would make little difference to its valuation of India as an ally. Increasingly Washington sees India as the middle portion of a democratic axis of friends that stretches from Israel to Japan.

Finally, a rising India is seen as the best counterbalance to China, whose emergence as a world power is taking place rapidly and without the assistance of external sponsors. Following the fifth anniversary of the 11 September terrorist attacks, many forget the fact that Mr Bush spent his first nine months in office thinking up ways to contain China, which he branded a 'strategic competitor'. One such method was to boost funding for Star Wars II, an anti-ballistic missile system that – if it ever worked – would partly be aimed at blunting China's growing nuclear reach. India was one of the first countries to welcome Star Wars II and request protection from it whenever – or if ever – the much derided programme bore fruit. Mr Bush did not forget New Delhi's immediate offer of support.

Six years later, New Delhi presides over a growing economy that is eliciting excitement from US investors. India also possesses a growing nuclear arsenal (thought to be at least 100 warheads) that Mr Bush's deal will help India to expand even more. There are many peculiarities to this strange relationship – and many critics as well. But few any longer doubt that India is emerging as a global power. Or that America is now helping it along.

Ed Luce's book *In Spite of the Gods: The Strange Rise of Modern India* was released in the UK on 24 August 2006 by Little, Brown and in the US on 16 January 2007 by Doubleday

India's booming private equity

Sahad PV, Editor and Publisher, VC Circle

In recent years, global private equity funds have found it increasingly difficult to justify not having a presence in India. Consequently, in the last two years, albeit almost a decade after Warburg Pincus set up shop in India, global 'biggies' like KKR, Blackstone, Bain Capital, Providence Equity Partners and Texas Pacific Group overcame their resistance to expanding into Asia's second fastest growing country. Clearly, the opportunities in India had become too attractive to ignore. However, what really opened their eyes was Warburg's 'multi-bagger' exit from Bharti Airtel in 2005. The US private equity firm netted about $1.6 billion from the sale of its stake in the Delhi-based telecommunications firm, more than five times its original investment of $300 million. It was proof that exits of such magnitude were possible for private equity investors in India. Suddenly, it made no sense to stay away from this market anymore.

The past year has seen the highest-ever private equity interest in India. KKR made a high profile entry last year with India's first buyout transaction, when they bought out Flextronics Software for $900 million. Another prominent global private equity firm, Providence Equity Partners, invested $400 million in Idea Cellular, one of the last telecoms properties available for private equity investment. Firms like Blackstone, KKR, The Carlyle Group and Texas Pacific Group also made a last ditch attempt to enter India's fast growing telecoms business by teaming up with one of the other suitors in the bid for Hutchison Telecoms International's 67 per cent stake in Hutchison Essar. In the end, UK mobile phone company Vodafone bagged the deal, but the interest from PE players is testament to the fact that India is quickly becoming a favourite hunting ground for buyout funds.

"Clearly, the opportunities in India had become too attractive to ignore."

According to a recent report by Thomson Financial, Indian companies attracted $2.2 billion in 143 private equity deals last year, the most in the Asia-Pacific region, excluding Japan. India overtook China, which came second with $1.7 billion from 145 deals, and pushed Singapore into third place with $1.5 billion from 17 deals. It looks like the deal-flow will only gather momentum: a 2006 study by Bain & Co forecast that India will receive as much as $7 billion by 2010.

The reasons for the private equity boom in India are three-pronged:

- India's domestic consumption is looking stronger than ever before. The economy is growing at an average of eight to nine per cent, and that makes a strong case for higher investments in healthcare, real estate, food services, banking and credit;
- India has an abundant low-cost and skilled labour force that brings with it unmatched competitive advantages. Because of this, sectors like software development, outsourcing of business services, engineering and architectural and technical design will continue to attract interest from investors. A partner at a US-based buyout fund told me recently that 'India has only started nibbling at the highly lucrative, multi-billion dollar global business services market'. He likened India's position in business services to that of the Asian Tigers when manufacturing shifted from the US and Europe to countries like Taiwan and Japan;
- India has a competitive advantage in certain niche areas in manufacturing such as pharmaceuticals, automotive components and metal forging. Here, too, private equity funds are looking to help Indian companies build global scale.

With a four-year continuous rise in stock markets, and multiple options for raising capital, the valuations in India may not be cheap. But private equity firms will continue to have an interest in India for years to come.

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Indian companies take AIM at overseas listings

Amit Chanda, Senior Associate, The Risk Advisory Group

Multi-billion dollar deals involving Indian companies such as Tata and Hutchison Essar have dominated the financial press of late, but even smaller Indian firms have been going global over the last 18 months. To New York's dismay and London's delight, many are seeking to raise capital on the Alternative Investment Market (AIM) of the London Stock Exchange. There were 11 issuances last year, raising upwards of £1.2 billion. This trend looks set to continue this year, with dozens of Indian companies – including the likes of Ansals (construction), Nicholas Piramal Group (pharmaceuticals) and Lok Housing (residential property) – planning an AIM listing. Thus, while 2006 may have been the 'Year of India' for London Mayor Ken Livingstone, 2007 is shaping up to be the 'Year of London' for corporate India.

The Indian Ministry of Finance is also in the midst of discussing rule changes that could provide an additional boost to companies planning AIM listings. According to a recent article in *The Times*, ministry officials are considering a proposal that would permit Indian firms a primary listing abroad, so long as they seek a secondary (domestic) listing within three years. Under current regulations, Indian companies are prohibited from listing equity shares overseas, though they may issue American or Global Depository Receipts (ADRs and GDRs) simultaneously with an Indian listing, or access foreign capital markets through institutional placements. Reflecting the view that AIM would stand to benefit from such a liberalisation, the British government has strongly supported the push to allow Indian firms a primary listing overseas, and the issue was raised by Gordon Brown in recent meetings with Indian Finance Minister Palaniappan Chidambaram in January. However, even without this deregulation, Indian companies have incorporated offshore vehicles to negotiate the current rules and ensure that London remains the listing destination of choice.

"... 2007 is shaping up to be the 'Year of London' for corporate India."

Although AIM has been in existence since 1995, it was virtually unheard of in India as recently as 2005. Since then, however, a number of companies – including Ishaan Real Estate, Hirco, Noida Toll Bridge, Great Eastern Energy and Indiabulls Real Estate – have capitalised on the advantages afforded by the LSE's junior market. Chief among these is the liquidity of the London-based exchange. Since its launch, over 2,500 companies (including 250 foreign companies) have joined AIM and raised more than £34 billion in the process, through initial public offerings and further share issues. Compared to exchanges such as Luxembourg, AIM's high trading volumes and access to a broad spectrum of investors offer Indian companies significant opportunities to fund their ventures.

Another element of AIM's appeal to Indian firms lies in its investor mix, with around 60 per cent being classified as 'long-term investors', who are prepared to invest in long gestation projects. This is beneficial for companies with extended time horizons, such as those involved in real estate, infrastructure, construction and natural resources. Most of the 20-odd Indian companies scheduled to list on AIM this year are engaged in precisely such business activities. These firms can find it difficult to sustain their valuations on domestic markets such as the National Stock Exchange (NSE), whose investors expect tangible dividends, quarter-on-quarter.

AIM's final – and perhaps most important – attraction for Indian companies has been its relatively lax admission criteria, though these are in the process of being tightened. Compared to the, at times, onerous requirements imposed by other leading bourses, such as NASDAQ, the New York Stock Exchange or even the Bombay Stock Exchange, qualifying for

AIM admission is quite straightforward: no minimum size of company, no minimum proportion of publicly-held shares, no trading record requirement, no transferability restrictions and no requirement to be incorporated in the UK. As the chairman of a London-based merchant bank told *The Telegraph* late last year, 'The most important attraction is that transparency and corporate governance standards are very low on the AIM market. It's ideal for an unlisted company which doesn't want to disclose much and doesn't believe in corporate governance.' Real estate funds in particular are said to prefer raising funds through AIM rather than via private equity investments because the latter prefer to do 'a very rigorous due diligence', reportedly 'much more than the exchange advisors do'.

However, lax AIM admissions and reporting criteria could soon be a thing of the past. Amid concerns that the lack of regulation has diluted the quality of companies on the exchange, the LSE has developed a 'rulebook' for the nominated advisors (nomads) of applicants seeking to list on the junior market. According to the new AIM Rules for Nomads (released on 20 February 2007), firms advising on an AIM listing will be held responsible for ensuring the 'appropriateness' of an applicant company and its securities, and will be expected to conduct thorough due diligence assessments to ensure that there are no material issues that could affect the applicant's standing on AIM.

It seems likely that these new rules will force nomads to conduct research into the track record and reputation of key principals, shareholders and management teams in order to confirm that the information they have provided is accurate and complete, and to ensure that there are no issues of concern which could damage the LSE's reputation by association, or otherwise cause embarrassment. While such research is relatively straightforward to carry out in jurisdictions like the UK and Western Europe, where high-quality public and corporate information is widely available, it can be considerably more challenging in other parts of the world, including India, but also Russia, Eastern Europe, the Middle East, Africa and Asia. Nomads advising applicants from these relatively unfamiliar jurisdictions may consider calling on experienced professional risk management consultancies to assist them in providing the integrity due diligence required by the new AIM regulations.

In the long term, the nomads' rulebook should improve the quality of companies listing on the junior market and bolster investor confidence in the exchange, but stricter requirements could also reduce the attractiveness of AIM for smaller and more entrepreneurial companies seeking to raise capital. That said, AIM still provides among the best platforms in the world for such firms to attract funding, and there is little reason to expect that Indian companies will be unduly deterred by slightly stricter regulations.

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Vodafone pays the 'India premium' for Hutch-Essar

Marc Einstein, Senior Analyst, Pyramid Research

Many investors believe that Vodafone has paid too much for its 67 per cent stake in Hutch-Essar. When the UK-based mobile giant dropped its first hint that it would bid for the asset in late 2006, its London shares dropped two per cent. When reports surfaced in early January 2007 that the company would be pipped to the post by Essar Group – already a shareholder in Hutch-Essar – Vodafone's shares actually rose 1.8 per cent. The news that the company had finally secured the asset with a bid of $11.1 billion was met with a gain in share price. However, one broker argued that the positive response was due more to the fact that Vodafone had seen off a bidding war with its Indian rivals, rather than a belief that it had 'paid the right price'.

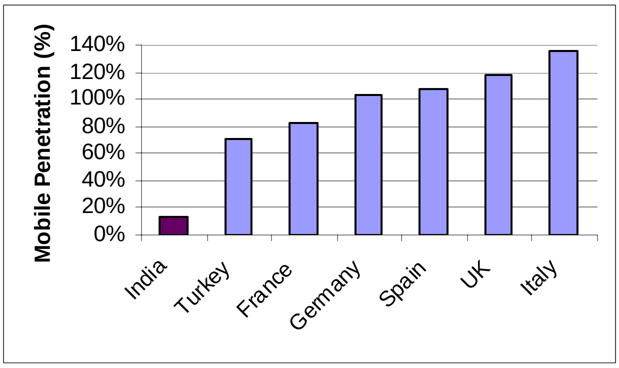
In this piece, Marc Einstein explains investors' concerns regarding Vodafone's move into India. He also underlines some fundamental aspects of the market that make the country hard for any multinational to ignore.

Vodafone faces a number of challenges as it moves into the Indian market. The first challenge is reaching customers; only 45-50 per cent of Indians live within the coverage area of a mobile network. Although the Indian government has set targets of 75-85 per cent coverage by the end of the year, significant capital expenditure will have to be made by the operators. Recognising this, Vodafone has already announced an agreement to share cell sites with competitor Bharti Airtel, although Vodafone's new partner, the Essar Group, has already expressed disapproval with the deal. The presumed introduction of 3G service in India next year will also lead to additional capital expenditures.

"… nowhere in the world is the cost of being outside the market clearer than in India."

India's mobile market is extremely competitive; churn rates in the market stand at around 76 per cent compared to 23 per cent in Western Europe. A consumer fixation with price and the presence of several operators has also driven prices for mobile voice service to some of the lowest in the world: the average price per minute stood at $0.02 in 2006.

Mobile penetration rates in selected Vodafone Markets, 2006

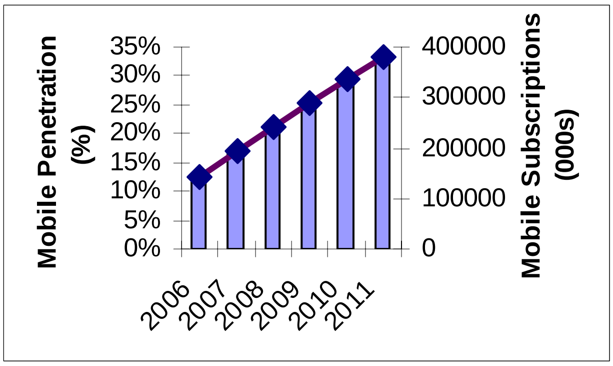


Cheap mobile tariffs result in very high minutes of use, which have in turn led to increases in expenditure on core networks. The Indian market is so competitive that in recent years operators have started offering prepaid cards with no expiration date, a rare offering in the Asian telecoms market.

Finally, for growth in the Indian market to realise its full potential, the price of mobile devices will have to fall considerably. In 2006, Nokia was selling its lowest-priced handset in the world for $43, but in a country with a nominal GDP per capita of only $774, such costs remain the largest barrier to entry. In recent months, vendors like LG and Huawei have made some progress in producing 3G phones which can be sold in the $100 range, although the $25 handset still remains elusive and its availability (or lack thereof) will have strong implications for our India mobile market forecasts.

Despite the risks, it is easy to see the rationale behind Vodafone's determination to acquire the Hutchison asset at almost any cost. There remain over 960 million Indians without a mobile phone and the market keeps growing. Pyramid Research predicts that the Indian cellular market will add around 237 million subscribers over the next five years, bringing the market to 380 million subscribers by 2011. This figure is on a par with the combined population of Vodafone's European operating markets[1]. This phenomenal growth will trans-

Indian mobile market subscriber growth and penetration, 2006-2011



late to an average of 3.95 million net additions every month for the next five years. This figure exceeds the number of subscribers that Vodafone has in many of its affiliated markets. Furthermore, Vodafone's core European markets are saturated, offering little potential for subscriber growth, putting the onus on the still-fledgling 3G market to deliver additional revenue.

So, perhaps the more pertinent question to ask is whether Vodafone could afford to lose an opportunity to enter India for the sake of a sensible market valuation? Such a conservative approach has arguably cost the company lucrative emerging market opportunities in the past. Saudi Arabia is one such example. Furthermore, nowhere in the world is the cost of being outside the market clearer than in India. The operational risks facing Vodafone are obvious, but so are the potential rewards. However, it is clear that Vodafone will have to learn how to do business in a different way to succeed in India's hyper-competitive, price-sensitive market.

For more information on Pyramid Research please email Marc Einstein at meinstein@pyr.com or visit www.pyramidresearch.com

[1] Vodafone has subsidiaries in the United Kingdom, Ireland, Malta, the Netherlands, Greece, Albania, Portugal, Germany, Italy, Spain, the Czech Republic, Romania, Turkey and Hungary. The combined population of these countries was around 397 million at July 2006, according to figures from the CIA World Fact Book.

Investing in Indian real estate

Preet Sethi, Associate Advocate, Kaden Boriss

Among emerging economies, India has one of the most liberal and transparent polices on foreign direct investment (FDI) and allows up to 100 per cent foreign investment in most sectors. Real estate development was previously one of the few restricted sectors, but even this was liberalised in 2005, with 100 per cent foreign ownership being allowed in townships, housing, built-up infrastructure and construction-development projects under the Automatic Route, subject to certain guidelines. In practice, this means that foreign entities can own up to 100 per cent of the equity of companies engaged in property development, and invest without requiring any prior approvals from either the government or the Reserve Bank of India.

The Indian government's primary objective in opening up this sector was to add to the housing and commercial real estate stock in the economy. With rapid economic growth, demand for quality real estate has multiplied, highlighting the urgent need to develop real estate infrastructure. As a result, real estate has become one of the fastest-growing sectors of the Indian economy, with market analyses showing that yields from property investment average between ten per cent and 12 per cent a year, making it an attractive sector for investors.

"... real estate has become one of the fastest-growing sectors of the Indian economy ..."

However, despite the liberalisation, FDI regulations on real estate development present obstacles to investors seeking to cash in on the boom. First, those wishing to benefit from investments in the property sector must be prepared to make large scale and long term investments in housing and infrastructure development projects. Current FDI guidelines require that a minimum land area of ten hectares be developed in the case of a project involving development of serviced housing plots, or 50,000 square metres in the case of construction development projects. Furthermore, a minimum capital investment of $10 million is required to set up a wholly-owned subsidiary, and $5 million for entering a joint venture with Indian partners. Moreover, the original investment cannot be repatriated for a period of three years from completion of minimum capitalisation, and an early exit is only possible with prior approval from the authorities. Given the forecasted returns on property investments, the lock-in period and minimum capitalisation requirements should not unduly deter investors.

There are, however, several hurdles that do present a more formidable deterrent, the first of which is the requirement of the minimum area of land to be developed under a single project. For a foreign player, finding ten hectares of land around major Indian cities will be a considerable feat, and even within the cities, finding property for developing 50,000 square metres (in the case of construction development projects) may also prove a challenge. Furthermore, it may not be possible for a private developer to acquire such a large block of agricultural land near a city, given the present ceiling of 15–25 acres of land per person on agricultural holdings. In practice, this would mean that contiguous chunks of land would have to be purchased from their different respective owners. This also explains why most of the recent urban and new city development projects have been carried out through public-private partnerships, in which the state government acquires land under the provisions of the 1894 Land Acquisition Act, and then sells this on to private players for development.

An even more significant obstacle for real estate investors would not be acquiring land, but rather obtaining the necessary approvals under the rele-

vant state and municipal laws. Each Indian state has its own set of laws, by-laws, rules and procedures, which govern planned development, the formation of housing societies and condominiums. Complicating matters is the fact that there is no 'single window' clearance mechanism for construction development projects, which means that it is up to the investing firm to secure the various approvals from the relevant government departments and agencies.

Consequently, foreign investors with little experience in the construction sector would be well-advised to consider entry via a joint venture with existing market players who have a sound project plan and track record, rather than pursuing fresh projects on their own strengths. Other options for experienced construction and real estate development investors to consider include Special Economic Zones, Free Trade Warehousing Zones and Industrial Parks or Industrial Model Towns. The development of these areas is governed by a different set of regulations and even in these, up to 100 per cent FDI is allowed under the Automatic Route.

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Special Economic Zones on hold

*Re-published courtesy of **Risk Briefing,** the operating risk service from the **Economist Intelligence Unit***

India's Special Economic Zones (SEZs) generated unprecedented excitement among domestic and international investors alike during 2006, but the recent decision to indefinitely freeze approvals has raised concerns that the SEZ party may be ending before it began. Inter-agency disputes between the ministries of commerce and finance, over the relative impacts of tax revenue shortfalls and increased foreign direct investment, have joined a growing political furore over the misallocation of agricultural land to bring the country's plans to a grinding halt. However, with the benefit of this self-imposed breathing room, it may also be possible for the Manmohan Singh administration to address other problematic elements of its SEZ plans and build a more enduring consensus among both the cabinet and the United Progressive Alliance coalition. While undoubtedly alarming to investors with projects in the pipeline, the freeze on SEZ approvals may yet prove to be a necessary and ultimately beneficial stage in the evolution of India's set-piece economic and industrial reforms policy.

"... the central government cannot be seen as favouring wealthy business interests over farmers ..."

India was the first country in Asia to establish an SEZ in 1965, but since that time it has fallen well behind the likes of China and Malaysia in extracting the economic and infrastructural benefits that such zones can offer. Part of the problem has been philosophical: having been quick to recognise the merits of establishing enclaves shielded from the distortionary trade, macro and exchange regulations prevalent in the mainstream economy, Indian leaders have never adequately established the objective of an SEZ policy. The execution of this ill-defined policy has been similarly beset by conflicting priorities and hesitancy, often with greater emphasis on quantity rather than quality. This is illustrated by the fact that since last year, 63 applications have been approved (with 237 more awaiting final clearance) even before the Commerce Ministry and Finance Ministry could resolve their differences over some fairly fundamental points of regulation.

As is the case with virtually every Indian reform measure, political calculations loom large for the coalition government, which appears to be perennially struggling to keep its allies onside and its rivals at bay. The recent decision to freeze SEZ approvals, for example, was driven almost exclusively by allegations that state governments are driving farmers off their land and profiting from the sale of this land to developers. The leader of the Communist Party of India (Marxist), Sitaram Yechuri, charged the Maharashtra state government with buying land from farmers for around Rs 50,000 ($1,135) per hectare before selling it on several years later to a corporate concern for Rs 620,000 ($14,100) per hectare. With state polls coming up in a number of key agricultural states, the central government cannot be seen as favouring wealthy business interests over farmers, hence Congress Party chief Sonia Gandhi's assertion late last year that 'agricultural land should not be diverted for non-agricultural uses'.

Much of the clamour about the misappropriation of farm land has been rightly described as political opportunism rather than outrage at a genuine social injustice. An analysis recently published by a major Indian newspaper suggests that the proportion of arable land that has been sanctioned for use by SEZs to date stands at a 'miniscule' 0.12 per cent of the country's total arable land. Moreover, the same report noted that 'the only way forward for bringing prosperity to the rural population' would require India to shift around 100 million workers from agriculture into industry and services over the next ten years. As such, the biggest concern about the government's recent freeze on SEZ approvals to develop a farmer-friendly rehabilitation policy is that it will focus on politically delicate minutiae at the expense of genuine problem areas.

Chief among the substantive issues requiring urgent attention is the open conflict between Commerce Minister Kamal Nath and Finance Minister P Chidambaram over the tax breaks offered to SEZ investors. The Finance Ministry has expressed worry that the scheme will cost the state Rs 1.75 trillion ($39.6 billion) in foregone tax revenues over the next five years. IMF Chief Economist Raghuram Rajan has echoed this criticism, claiming that such tax

breaks would cause the government to 'forego revenue they can ill afford to lose'.

Even some investors, notably Bajaj Auto Chairman Rahul Bajaj, have claimed that the incentives in place for manufacturers, which include a five-year profit tax holiday and exemption from import and excise duty and certain licensing requirements, are too generous. There are also concerns that the qualification criteria – that manufacturers simply be net earners of foreign exchange over a five-year period – are too lax. Certainly the example of South Korean steelmaker Posco vindicates critics of the current SEZ regime. The company had already planned to commit $12 billion towards the development of an iron ore mine in Orissa state, but recognising the incentives available, applied for and received approval to classify itself as an SEZ, depriving the central and state governments of an estimated Rs 1.15 trillion ($25.32 billion) in excise and customs duties, and various corporate, sales and value-added taxes over the next 30 years.

The Commerce Ministry, backed by leading figures in corporate India, has responded to criticism of the 'sops' being offered to exporters by pointing out that the additional anticipated economic activity – which includes an anticipated $30 billion in foreign investment – and two million new direct and indirect jobs, will more than compensate for the loss of tax revenues. However, few in the Indian administrative apparatus share the Commerce Ministry's bullish projections. The Reserve Bank of India, for example, has advised domestic banks to treat exposure to SEZs as if they were real estate loans as opposed to infrastructure projects. There are genuine fears, not altogether unfounded, that there is greater speculative interest in buying and developing SEZs than there is establishing export-oriented manufacturing operations within them.

For these reasons, the current freeze on SEZ approvals – while unsettling to some – may give the government a moment to take stock of the popular and yet controversial policy that it unveiled a year ago, and assess how to improve its political, economic and social viability. Singh has already said that 'SEZs have come to stay', so policy stability is all but assured. The question now will be, what India's SEZ policy will look like when it is reinstated. The realities of India's coalition, consensus-driven political system dictate that legislation must be adjusted and finessed to secure crucial compromises. This means that there could be more stringent conditions for the use of land within an SEZ, reduced tax breaks or even loose quotas on the number of SEZ approvals. However, even if the new-look SEZ plan is marginally more restrictive than its predecessor, interest in these zones is expected to remain high. As Amit Mitra, director general of the Federated Indian Chamber of Commerce and Industry (FICCI), said, 'foreign investors are beginning to come in, but they are waiting for 100 per cent clarity of policy'. Hopefully, they shall not have to wait too long.

Re-published courtesy of *Risk Briefing*, the operating risk service from the *Economist Intelligence Unit*

Terrorism: targeting India's economy

Christina Corbett, Associate, The Risk Advisory Group

The 19 February bombing of the Samjhauta Express train travelling between India and Pakistan marked the latest major terrorist assault against civilians on Indian soil. While the mode of this attack – explosive devices placed inside a passenger train – is a familiar one, the country's security services are increasingly concerned about the prospect of less conventional attacks in future. In particular, there is growing evidence to suggest that radical groups are developing plans to strike economic targets, particularly those located in the southern regions of India.

India's software and business processes outsourcing (BPO) industry is a significant economic target for terrorists. The arrest of a suspected militant on 5 January 2007 on the outskirts of the southern city of Bangalore, India's high-tech and BPO centre, is the most recent security-related incident involving the sector to serve as a reminder of the threat. In an intelligence-led operation, Bangalore police arrested a man travelling into the city by bus from Hospet, a city about 220 miles north-west of Bangalore. He is reported to have been carrying an assault rifle, ammunition, a satellite phone, SIM cards and a map of the city. According to local media, among the locations marked on the map were Bangalore airport and the offices of Wipro Technologies Ltd and Infosys Technologies, two of India's largest software and IT services exporters.

"India's software and business processes outsourcing (BPO) industry is a significant economic target for terrorists."

The satellite phone and SIM cards are indicative of a larger and more sophisticated operation at work behind these potential attacks. Successfully targeting India's high-tech industry and BPO sector, business that has been vital in driving India's economic growth, could have a significant impact on the country's continuing economic expansion. This would deliver a powerful signal to the Indian government where other attacks have proved less potent.

India's outsourcing industry is estimated to be worth more than $23 billion, employing around 1.2 million people, about 35 per cent of these in Bangalore. Bangalore is home to more than 1,500 information technology and outsourcing firms, with the highest value of IT-related exports in the country. A large number of IT firms in Bangalore are based in the Electronics City industrial park, which covers 330 acres on the outskirts of the city and is home to several major companies, including Hewlett-Packard, Motorola, Infosys and Siemens. It is also home to the Indian Institute of Science (IISC), one of India's oldest research institutes.

A series of incidents over the past two years has highlighted the vulnerability of the high-tech industry as a target for terrorists. In March 2005, an anonymous caller warned that bombs had been planted in the Bangalore headquarters of Wipro and Infosys. The calls were hoaxes, but in a police raid in Delhi earlier the same month, documents had been found indicating that suspected Kashmir-based militants were planning to carry out attacks on such companies in Bangalore.

Since then, Indian Prime Minister Manmohan Singh has confirmed that the country's high-tech industry is at risk. In December 2005, an attack on an IISC conference by heavily-armed gunmen wearing ski masks and camouflage uniforms resulted in several casualties. In January 2006, two men suspected of planning attacks against the IT sector in Hyderabad were arrested, and in March, city police increased security in response to what was believed to be a credible threat against customer service and business processing support centres. For the same reasons, security at Bangalore's Western-owned IT centres was increased in August. In October, two men were arrested after engaging security forces in a gunfight on the outskirts of Mysore, another important city in India's software sector.

Indian officials have traditionally blamed Islamic radicals, particularly groups such as Lashkar-e-Toiba (LeT) and Students Islamic Movement of India (SIMI), for playing a central role in such incidents. LeT, or Army of the Pure, a Kashmiri separatist organisation that has been linked to Osama Bin Laden's network, has a history of violence in India. The group maintains a known capability to launch attacks on Indian soil outside Kashmir and pursues a desire to destroy a Hindu India. LeT is believed to have been involved in the co-ordinated train bomb attacks in Mumbai in July 2006. Nearly 200 people were killed in the incident. The group is also believed to be responsible for two car bombs in the city in 2003, and for attacks against the Indian parliament in New Delhi in 2001.

SIMI is a group advocating an Islamic revolution in India and the initiation of a world-wide *jihad*. Indian security forces have reported that SIMI has established links with other militant groups, including the LeT, and the group has been held responsible for a number of terrorist attacks in India. They are believed to have been involved in both the 2003 Mumbai car bombings, and in last July's train bombings. Most recently, they were believed to be among terrorist groups, including LeT, that were planning a terrorist attack during the India-West Indies one-day international cricket match in the western city of Cuttack in January.

As the peace process with Pakistan develops a greater resilience to isolated terrorist outrages, security officials are concerned that groups like LeT and SIMI could change tactics and focus on other, perhaps more vulnerable, types of soft targets. Chief among these are the icons of India's high-tech industry, which have symbolic value as the drivers of the country's economy. Foreign and domestic IT firms must be aware of the threat they face. Comprehensive contingency plans to deal with such attacks are essential. These must involve thorough security risk management assessments and business continuity plans. There is an emerging and credible threat to companies operating in India's software and outsourcing industry. These businesses should make sure that they are well-protected should they find themselves as the next targets of terrorist violence.

Christina Corbett is an Associate at The Risk Advisory Group. If you would like to know more about this topic, please contact her at christina.corbett@riskadvisory.net

THE RISK ADVISORY GROUP

INDIA: PROSPECTS FOR CROSS-BORDER INVESTMENT
A BREAKFAST DISCUSSION FOR BUSINESS

Wednesday 28th March 2007
08:00 – 10:00
St Stephen's Club, 34 Queen Anne's Gate, Westminster, London SW1H 9AB

The Risk Advisory Group would like to invite you to a breakfast meeting on India and the prospects for cross-border investment. There will be brief presentations from the following individuals, who will share with you their experiences and impressions of investment into and out of India:

Shiv Khemka, Vice-Chairman, SUN Group
Christopher Horton, Senior Associate, Lovells
Anuj J Chande, Partner, Grant Thornton LLP

The presentations will be followed by an informal discussion chaired by **Philip Keevil**, a non-executive director of The Risk Advisory Group.

The session is designed to allow business professionals to learn more about the risks and opportunities involved in investment in India and what the future holds for business between the UK and India.

Attendance is by invitation only. Places are limited so book early to avoid disappointment. There will be an opportunity to network from 08:00 until the start of the presentations at 08:30.

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