What **executives are asking** about India

The head of McKinsey's Indian offices addresses the concerns of senior multinational executives.

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The world's senior executives, many of whom were slow to recognize China's vast potential, are flocking to India for fear of missing out on one of the last great growth stories. But the country and its economy present a mosaic of contradictions. India is a stable democracy, but an undercurrent of religious and ethnic tension remains. Cities such as Bangalore and Hyderabad are bustling high-tech centers, but Mumbai, the financial and media center, is a confusion of gridlock and slums. Foreign investment is desperately needed, especially to build the manufacturing sector, but India has been painfully slow in opening up many of its markets.

Shakila
Collage on canvas
79 × 91.5 cm
2002

Over the past year alone, McKinsey has talked with leaders of more than 100 multinational corporations that are operating in India, preparing to do so, or wondering if they should. The following questions and answers, based on McKinsey's experience with government officials and businesses across the country, address some of the more common issues they raise.

Will economic reform continue?

The momentum behind reform is irreversible, for it is driven by a collective belief that India must have a strong economy to improve its standard of living, to be taken seriously by the world, and, not least, to keep pace with neighboring China. Both major political parties—Congress and the

Article at a glance

India presents a tempting opportunity—and a puzzle of contradictions—for many multinational companies. The head of McKinsey's Indian offices addresses some of the more common questions.

The country's noisy democracy obscures a stable economy. Reforms begun in 1991, backed by the country's major political parties, are irreversible.

Although the government wants the country to receive more foreign direct investment, measures are needed to open the taps fully.

Companies shouldn't feel forced to choose between India and China. They should engage both, taking advantage of the strengths and opportunities of each.

Bharatiya Janata Party (BJP)—are committed to the economic reforms begun in 1991, when Manmohan Singh, now the prime minister, was the finance minister. Despite the change of leaders in 1996 and again in 2004, India has moved unwaveringly in the direction of reform. As the benefits of strong growth are felt across the country, this political support will be sustained.

Still, India's political cacophony perplexes many multinational executives. The country is a stable but noisy democracy. All manner of political parties have their own media organs, and headlines magnifying the objections to reform scream from every newsstand. The acrimonious debate obscures an underlying consensus on the benefits of continued change.

Not that coalition politics hasn't affected the pace of reform. After one year in power, the prime minister himself gave the government low marks for implementing the Common Minimum Program, a blueprint for change agreed upon by the coalition partners. Little has been done to cut the budget deficit (a burdensome 8 to 9 percent of GDP), to relieve the problems of India's poorest people, or to embark on new reform programs. The Communist Party, whose support sustains the governing coalition, has blocked privatization and efforts to relieve the special economic zones from the burden of restrictive labor laws. Much work remains if the government is to accelerate economic growth to 8 to 10 percent—the level needed to stave off increasing unemployment—from the current 7 percent, in three to five years (see "Why believe in India," in this issue).

The government should nonetheless receive credit for refusing to back away from the reform programs already in motion, as some observers thought it would after the 2004 elections. And some progress has been made, over the past year, in promoting foreign investment and establishing a value-added tax, among other things.

But the state governments, which hold considerable power in India's decentralized democracy, sometimes slow the pace of reform. Much of the country's mineral wealth, for example, remains undeveloped because of

certain recalcitrant states. Meanwhile, those run by more progressive parties are free to undertake reforms and to solicit foreign investment more actively than their neighbors do. Karnataka, Maharashtra, and West Bengal, for example, are blazing a trail for others to follow.

Are the multinationals really welcome?

Foreign direct investment has increased since the start of the reforms, but inflows are still anemic, especially compared with the amount China attracts. In the past fiscal year, India took in about $5.5 billion in foreign direct investment, about 8 percent of China's $64 billion. Recognizing the need to increase the flow of foreign funds, the government has pledged to raise annual foreign direct investment to $15 billion within three years and to $50 billion within five. The prime minister has established an investment commission to attract foreign capital, is encouraging Indian executives abroad to invest in India, and has met CEOs from many large multinationals and promised to clear the investment hurdles they face.

But a patchwork of national and state regulations continues to hamstring investment strategies. In many industries, foreign companies find acquisitions harder to make in India than in most other emerging markets. Mining and power generation, for instance, are closed to all but the most determined investors. The government had to work with one of them—South Korea's Posco—to overcome local resistance in the state of Orissa to a $12 billion project combining iron ore mining and steel production. That deal represents the largest single foreign investment in India.

In many sectors (such as air transportation, construction, and telecommunications) investment restrictions are falling more quickly. Hutchison Telecom, SingTel, and several private equity firms are placing bets on the burgeoning mobile-phone market. The government has promised to liberalize other industries during the next few years; retail banking, for instance, is set to be opened up in 2009.

Restrictions on foreign ownership are hardly the only issue making India a less-than-attractive place for many multinationals contemplating investments. Labor laws, for example, prevent a company with more than 100 employees from firing any of them without the state government's approval—a roadblock for any business that might consider building a large-scale factory to take advantage of India's low labor costs. Paradoxically, auto parts makers and other companies have used capital-intensive business models to stay below this regulation's threshold.

Red tape is also a disincentive. The World Bank estimates that Indian senior managers spend about 14 percent of their time dealing with regulatory issues (compared with about 8 percent for their Chinese counterparts).

Starting a business in India takes 89 days, on average—more than twice as long as in China. Closing a business is just as difficult. Reducing or removing such barriers would show that the government is serious about meeting its targets for foreign direct investment.

Isn't China the richer opportunity?

India is at an inflection point. Consumer demand is growing three to five times faster than the overall economy. In telecommunications, for example, the number of mobile-phone subscribers has risen from 2 million three years ago to 55 million today, and it is projected to reach 250 million within five years. Airline traffic is also soaring, from 12 million passengers in 2000 to an estimated 47 million this year, and it is forecast to grow by about 20 percent annually over the next five years. In financial services, every product category is exploding.

*India's **consumer demand** is currently growing three to five times faster than the overall economy*

China's economy is in a later phase. Multinational companies shouldn't choose between India and China; they should aspire to engage both. Companies that enter India now can build advantageous positions that will be almost impossible (and very expensive) for latecomers to duplicate; delaying by just three years could increase the cost of entry tenfold. Companies that missed getting into China early shouldn't repeat that mistake. Those with strong positions in China should remember that they were built by getting in early.

Although India's growth potential in many sectors is second only to China's, India isn't a place for anyone hoping to make a quick rupee. Companies that have endured the inevitable downturns have done well, but many of those that arrived during the boom of the late 1990s left in frustration after the slowdown of 2002–03. The opportunities are vast, but reaping them takes staying power and investment.

In addition to the opportunities presented by the world's tenth-largest economy, there are strategic reasons for operating in India as well as in China. Two stand out. First, companies should be wary of relying heavily on a single source of supply; India can help to diversify supply chains, particularly in manufactured goods and textiles. Second, India remains richer in technical talent—an advantage that could complement China's manufacturing prowess for multinationals active in both countries.

How do successful multinationals approach India?

Foreign companies have been active in India for years, sometimes decades. Citigroup, Hindustan Lever (Unilever's Indian arm), and ITC are among the successful multinationals with a long-term presence there. Other

multinationals—Hutchison Whampoa, LG Electronics, and Samsung, for instance—have built businesses with more than $1 billion in annual revenues in just a few years.

Successful foreign companies in India share three characteristics. First, they have invested for the long term and made a strong organizational commitment by assigning senior managers to work with established local teams. One of the biggest mistakes is treating the country as the "flavor of the month," with the CEO and senior executives flying in to announce an investment without thinking through the commitment required for success. Inevitably, top management's attention then wanders off to the next big thing, and a small group of managers remains to carry on the struggle without sufficient resources.

Second, the successful companies have adapted their businesses to local conditions rather than forcing foreign models on India. In general, prices are substantially lower there, so products and supply chains must be radically redesigned to cut costs. Successful companies also assemble national third-party distribution systems to bypass fragmented local ones. This model, when implemented well, can be a source of long-term advantage (see "Winning the Indian consumer," in this issue).

Finally, multinationals that succeed in India help to create and shape the market. Hindustan Lever, for example, created a new category for personal-hygiene products and expanded the market considerably by offering single-use sachets of shampoos and other soap products. Unit prices are low, but prices by volume are higher than those of larger-sized packages.

Is offshoring in India worth the political risk?

Offshoring has become a volatile issue in Europe and the United States. If the world economy remains sluggish and unemployment rises in developed countries, the debate could intensify. Yet the initial impact, paradoxically, has been to create a higher awareness of the advantages of offshoring, particularly for small and midsize businesses, and to make the practice more common. Should politicians in the developed world succeed in passing protectionist legislation, the debate's long-term impact could be less benign for companies that are seeking to cut their costs. But convincing arguments justify weathering the storm and extracting more value from offshoring.

As the offshoring sector evolves, globally and in India, the focus will expand from reducing costs to exploiting value-added opportunities and generating revenues. One multinational finance group created an analytical group in Delhi that uses sophisticated mathematical models to examine

transactions. Low labor costs allow the group to analyze even small ones. As a result, the company has prevented about $50 million in attempted fraud and approves many more transactions than it did before. Airlines, telecom providers, and other companies serving a large customer base can use this sort of analytical talent to improve their marketing and to scrutinize suspect transactions.

But India's offshoring success has generated more and more demand for its skilled workers. About 150 foreign companies have set up offshoring subsidiaries there, and they compete for talent with local suppliers such as Infosys Technologies, Tata Consultancy Services, and Wipro Technologies. Recently, the demand for skilled software engineers and managers has pushed salaries higher and triggered a talent war for the best people, particularly in IT centers such as Bangalore and Hyderabad. Multinationals should be aware of these trends when they calculate the benefits of offshoring, though efforts are now under way to increase the supply of suitable Indian workers (see "Ensuring India's offshoring future," in this issue).

Will infrastructure be a problem?

For years, the government neglected India's crumbling infrastructure, and the costs of that neglect are now obvious. The World Bank indicates that a lack of reliable, reasonably priced power is the single largest constraint on the country's businesses. In 2003, the bank reports, 61 percent of them owned their own power generators to compensate for frequent service interruptions (about 17 a month, compared with fewer than 5 in China). Dangerously overloaded passenger trains, gridlocked city roads, and aging airports all show that something is wrong.

Only recently has the government recognized that resolving these problems will be essential for growth. Plans are now afoot to improve broad swaths of the infrastructure. Over the next three years, the central and state governments plan to raise their annual investment in it to $35 billion, from $20 billion. To augment these funds, they plan to attract private investment. (The Posco steel mill, for example, included a $900 million project to build a seaport in Orissa.) "Special-purpose vehicles"—public-private partnerships to attract foreign money—have been created to finance specific projects.

Improving India's power system alone will require $45 billion in public and private investment during the next three years. Any delay could hurt the entire economy, so the government is working to liberalize the market, though it is proving difficult to devise payment systems in concert with

local electricity boards and to create an open market for selling power over the national grid. What's more, coal to fuel power plants is in short supply. In one indication of the national government's commitment, however, it has worked hard to restart a 2,184-megawatt power plant closed in 2001 by the Maharashtra state authorities over a debt dispute. A four-year stalemate involving the US investors, Bechtel and GE Capital, has now been broken, and the $2.9 billion plant is expected to be back on line in 2006 (see "Securing India's energy needs," in this issue).

Even in the rosiest scenario, India's infrastructure problems will take several years to resolve. Inadequate power, ports, and roads are especially troublesome because they raise energy- and logistics-related costs—for example, by forcing businesses to keep higher-than-optimal inventories and to buy stand-alone power generators. As the situation improves, these costs will slowly fall.

Will India protect intellectual property?

Earlier this year, India passed a milestone in the protection of intellectual property. Despite loud protests from nongovernmental organizations and some domestic politicians, the parliament approved a new patent protection law that prohibits Indian companies from copying the products of other companies. This legislation—a response to pressure from the World Trade Organization—was aimed primarily at pharmaceutical manufacturers, which have expanded by making cheap knockoffs of patented medicines. Yet India's major pharma companies backed the change: many of them have matured from copiers into innovators, so they also now need the added protection.

In other industries, too, the new law has raised confidence that intellectual property will receive protection. Monsanto, for example, is now marketing genetically altered seeds in India. *Harry Potter and the Half-Blood Prince*, helped by an unprecedented push on the part of its publisher, sold close to a quarter of a million legitimate copies in the country on the first day of its release—20 times more than any other book ever had. Now that the new protection is in place, the government must enforce it or risk losing the goodwill (and sales) it is generating. Q

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