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Asian Corporate Governance Association (ACGA)

ACGA India Delegation – Member’s Briefing

Presentation by
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Agenda

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II. **Economic Backdrop**

III. **Regulatory Highlights**

IV. **Corporate Performance**

V. **Key Governance Issues**

I. Political Landscape (1/2)

- **Forthcoming Elections**
- **In April/May 2014 the world's largest democracy will go to the polls to elect the 543 seats of the Lok Sabha (lower house) which will form the new government for the next 4-5 year term.**
- **272 seats are needed for a majority and 180 for leading a coalition.**
- **Government is currently led by the UPA Congress coalition holding 259 seats.**

- **UPA Congress Government**
- **Embattled government has struggled with a series of scandals and problems including:**
  - **2G and Coalgate corruption scandals;**
  - **Low growth and high inflation;**
  - **Policy paralysis;**
  - **Separatist movements and calls for the bifurcation of key states;**
  - **Inability to kick-start much-need investment in critical infrastructure projects.**
- **Pinning hopes on Rahul Gandhi as the youthful (untarnished) face of the Party.**

- **Main Opposition**
- **Narendra Modi led BJP are the primary opposition party that had historically opened the doors to the liberalisation of Indian markets.**
- **Modi is a divisive figure in India building his reputation equally on progressive economic policies in his home state of Gujarat and his perceived complicity in India's worst incidents of communal violence.**

I. Political Landscape (2/2)

- **Main Opposition Cont.**
  - **BJP is undisputedly the choice of the business and investor community (74% of corporate leaders back Modi over Gandhi while stock markets hit historic highs after recent BJP state victories).**

- **Possible Outcomes**
  - **Indian elections are impossible to predict due to the inaccuracy of polls (bias towards urban voters). Polls currently point to a BJP led coalition coming to power.**
  - **BJP victory is also being extrapolated from recent successes in state elections particularly in Rajasthan which saw a huge swing from Congress to BJP (162 to 21 seats).**
  - **Congress will be banking on support from rural areas which it has wooed through the Food Security Bill as well as capitalising on the politics of fear from minorities. However, onion prices and its historic role in bringing down governments means the poorer classes are not a safe bet.**
  - **Wild card is rise of new parties such as Aam Admi Party (anti-corruption movement) which won a surprising victory in Delhi and will be fielding 350 candidates in the elections. There is now increasing uncertainty as to which parties votes they are likely to cannibalise.**
  - **BJP victory should result in more business and investor friendly policies with Goldman Sachs predicting a positive country re-rating. However, possibility of communal unrest looms.**
  - **Worst case scenario (although highly possible) is hung parliament. India has a terrible record of political differences being pursued above the interests of the country and much needed economic reforms will likely be placed on hold. This will severely hamper FDI and undermine growth.**

II. Economic Backdrop (1/2)

- **Growth Rates**
  - **Last year GDP growth dropped to 5% (lowest in a decade) with optimistic projections of 6.5% for the following year. 5 year plan targets (2012-17) have now been revised down to 7.5% which is still very ambitious.**
  - **Key underperforming sectors include agriculture, mining, energy and manufacturing.**
  - **World Bank recently revised down its 2014 growth projection to 6.2%.**

- **Currency Woes**
  - **The Indian rupee plunged to a record low versus the dollar at 68.85 in August before gradually recovering to 61.8 by year-end. Resulted in a big sell out of Indian equities during the summer.**
  - **Key reasons included:**
    - **Record current account deficit of $88.2 billion in 2012–2013 (4.8% of GDP);**
    - **Bottlenecks in attracting foreign direct investment, resulting in decline of 38% to $22.42 billion, in 2012–2013.;**
    - **Impact of the imminent Fed tapering (effected all countries in region with India and Indonesia worst hit) .**
- **Inflation**
  - **Retail inflation above 11% with politically sensitive food price inflation above 14% (highest of any major Asian economy).**
  - **High inflation coupled with low growth (considered stagflation in Indian context) has posed challenges for Raghuram Rajan, new RBI director in setting policy. Raised interest rates twice and market waiting for ‘calibrated’ strategy in 2014 targeting low inflation and growth stimulus.**

II. Economic Backdrop (2/2)

Infrastructure Development

- **India infrastructure is ranked 84th out 144 countries (Global Competitiveness Report) and is considered the primary drag on the economy.**
- **Government signalled firm intent with planned infrastructure spending increasing to $1trn in current 5 year plan, representing 10% of GDP (40% from private investors).**
- **Over 100 major projects (according to Finance Ministry) have full funding but yet to commence because of regulatory red tape and lack of fuel.**
- **Big push to get projects started at a ministerial level but little actual progress. Environment Minister has been changed twice recently to try and appoint a more business friendly face.**

Foreign Direct Investment

- **Loosening of rules governing FDI across multiple sectors including multi-brand retailing and telecoms.**
- **However, policy uncertainty remains high which has continued to discourage investment – corruption, tax framework (Vodafone & retrospective changes), threat of policy changes (Delhi u-turn on multi-brand retailing), onerous conditions on investment and permit processes.**
- **Significant projects withdrawn due to difficulties in gaining environmental clearances, land and other legal obstacles – notably Arcelor Mittal, Posco and Wal-Mart terminating local JV.**
- **Needs to be resolved quickly as growth projections and development plans are highly dependent upon foreign capital. However, divisive subject in country and popularist policies are likely to accentuate uncertainty.**

III. Regulatory Highlights (1/2)

- **Companies Act**
- **Long awaited Companies Act was finally passed into law in August 2013. Key CG related provisions in the Act include:**
  - **Board –** 1/3 independent boards, mandatory nom + rem + audit and CSR committees, 1 female director.
  - **Audit –** Establishment of independent oversight body, mandatory rotation, restriction on non-audit services.
  - **CSR –** requirement to spend 2% of net profits on CSR (comply or explain).
  - **Misc. –** electronic voting, transparency and approval of RPTs, class action law suits, restrictions on director loans, easing of restrictions on M&A, new tribunal process.

- **Insider Trading**
- **Priority area for reform in 2014. Just completed public consultation on comprehensive revisions to framework:**
  - **New definition of insider, connected person, and unpublished price sensitive information.**
  - **Importantly public servants and family members of connected parties will now be captured by legislation.**
  - **Trading by insider will only be allowed based on pre-determined trading plan.**
  - **Companies and all relevant related parties (brokers etc.) required to have published code of conduct/ethics addressing trading restrictions and whistle-blower protection.**

III. Regulatory Highlights (2/2)

- **Clause 49**
- **In Feb SEBI finally approved the revisions to the governance listing standards, a full 12 months after the closing of the public consultation. Delay was due in part to fierce opposition from corporates.**
- **The revisions were designed to keep pace with the Companies Act and also adopt global best practice. Key issues included:**
  - **Board –** limit of tenure of INEDs, restrictions on board directorships, board evaluations, INED only meetings, succession planning processes, and appointment of a female director;
  - **Remuneration –** enhanced disclosure of remuneration policy and pay, prohibition of options to INEDs;
  - **Other –** expanded role of audit committee in RPTs and shareholder approval by minorities of material transactions, whistle-blower systems and e-voting.
- **The new rules will come into force on 1 Oct 2014. However, there are currently > 900 companies that are not compliant with the existing rules – enforcement remains the key issue.**
- **Misc.**
- **Land Acquisition Act – Finally passed into law replacing 1894 Act (from British rule). Land acquisition problems account for substantial delays in critical projects (Posco- Odisha). Key aspects of the Act include increased compensation (up to 4 times market rate), new consent thresholds, relocation & rehabilitation, dispute resolution, and compensation to land users.**
- **Lokpal Act – (Jan 2014) Anti-graft body covering all public officers including PM. Highest authority superseding CBI. Parties reluctantly passed the Bill leading up to the national elections due to AAP sentiment spreading. However, lack of clarity on how it will be implemented.**

IV. Corporate Performance

- **Stock Markets**
  - **Sensex grew by 9% in 2013 despite the temporary plummet in August (peak of the currency crisis). Best performer out of the BRICs. However, Sensex down 3% in dollar terms.**
  - **In December both Sensex and Nifty hit record highs finally making up the 65% drop experienced at the time of the financial crisis in 2008. Markets buoyed by RBI actions and political prospects.**
  - **Growth has come from blue chips with mid and small caps dramatically underperforming, reversing the trends of 2012. BSE Midcap Index down 6% during year.**
  - **Outlook positive with market/GDP, PE ratios and ROE below long-term averages.**

- **Ownership**
  - **Promoter holdings in BSE 500 rose slightly to approx. 50% with FIIs holdings rising to around 21%.**
  - **7 companies have FII ownership > 50% with HDFC leading pack with 74% (significant increase during the year despite underperforming share price (fell by 4% in 2013).**

- **Best Performing Stocks**
  - **Technology and pharma stocks performed strongest driven by foreign (US) demand and cheaper rupee. Tata Consulting Services up - 73%, Wipro - 61% and Sun Pharma – 54%.**

- **Worst Performing Stocks**
  - **Companies with significant exposure to the domestic market particularly in infrastructure and lending struggled the most. SBI down 26%, BHEL 23% and Tata Power dropping 17%.**

V. Key Governance Issues (1/2)

- **Board**
  - Dominance of representatives of the promoter family in positions of CEO/Chairman
  - Lack of depth of executive talent.
  - NEDs lacking appropriate skills, experience and diversity or independence from promoters.
  - Succession planning – particularly in controlled companies.
  - Lack of independent approval process for RPTs (2,326 RPTs in 2013 with largest transactions involving Reliance Industries, Adani Enterprises and GMR Infrastructure). Addressed to some extent by new regulations.

- **Executive Compensation**
  - Promoters pay themselves significant sums as a means of extracting value from the business with lack of visibility on performance targets (46 companies paid > £1m and 144 > £500k).
  - BSE 100 – Average pay for Promoter CEO was more than double non-promoter CEOs. While numbers are lower than western markets, India fairs poorly when calibrating numbers against revenue generated. Highest earners were husband and wife promoters of Sun TV who took home more than £10m in 2013.

- **Audit & Controls**
  - Real concern over experience of committee members and quality of oversight of auditors.
  - Fragmented audit industry dominated by small firms with questions over expertise and capacity to deal with large clients. Auditor rotation mandated in Companies Act is likely to make things worse. New Independent Oversight Body may enhance audit quality over time.

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V. Key Governance Issues (2/2)

- **Bribery & Corruption/Fraud**
- **Represents the single greatest governance risk in the country and takes multiple forms:**
  - **Group-wide fraud led by the promoters – NSEL;**
  - **Bribes paid to government officials – Telecoms, Coal;**
  - **Accounting fraud – Reebok India;**
  - **Falsification of disclosures to regulators – Ranbaxy;**
  - **Employee level and vendor related fraud – Novartis India (most common but least material)**

- **M&A**
- **2013 saw 500 deals worth $27bn showing a steady decline over last two years. Mostly inbound due to continued interest in the Indian consumer and healthcare sectors and stake enhancement by multinationals in their listed subsidiaries. However, analysts projecting sharp uptick in 2014 due to easing of legislation and dynamics of local & global economy.**
- **Apollo Tyres failed bid for Cooper Tire & Rubber epitomised the risks associated with large scale M&A activity by Indian firms:**
  - **Motivation of senior management (empire building etc.);**
  - **INED Involvement - lack of rigour in board debate on strategy, valuations and oversight;**
  - **Financing – tend to be highly geared deals which depress share price post acquisition;**
  - **Poor due diligence – dealing with labour unions and other factors which are not as commonplace in India.**

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