INDUSTRIAL INVESTMENT TRUST LTD.

Annual Report
1996-97

IIT GROUP

INDUSTRIAL INVESTMENT TRUST LTD.

Chairman's Statement
1996-97

IIT GROUP

Ladies & Gentlemen,

I should like to extend to you my warm welcome to the 64^{th} Annual General Meeting of your Company. The Notice of the Meeting, together with the audited accounts for the year ended 31^{st} March, 1997, has been in your hands for some time. With your permission, I should like to take these documents as read.

TIMES OF CHANGE

As the millennium approaches, the entire spectrum of Indian industry is going through a process of dramatic change. The financial services sector is no exception. It has benefited from, and by the same token suffered as a result of liberalisation. In these times of change, the IIT Group has continued its policy of caution, with a commitment to preserve *long-term* shareholder value. The Directors of each respective *IIT Group* company concluded that this was a time for reserve, not for wanton distribution. "Cash is king" – this old adage holds truer today than ever before! Many of you are long-term investors and will therefore appreciate the merits of this traditional, careful approach to nurturing your Company. Just consider *how* many corporates today are *over*-leveraged, with profits depressed due to the high cost of borrowed funds. But equally, our banks must learn better how to manage risk and become more effective in catalysing growth through properly appraised lending; they *have* the funds, they must *use* these funds, wisely.

The present Union Government, albeit a minority Government comprising 13 political parties, has continued steadfastly in the process of liberalisation. The Finance Minister must be complimented on his commitment to financial discipline, as also to the ongoing reduction in both personal and corporate tax rates. India today is a relatively low-tax country. But *only* if we are able to bring profligate Government spending under control, concurrently collecting higher tax revenues, shall we be able to reduce the enormous fiscal deficits we have experienced in recent years. And long overdue legislative reforms in areas such as Company Law, Foreign Exchange Management, etc., with an acceleration in the availability of due legal process, will boost confidence.

Whereas I shall focus on the financial sector in this Statement, I would like to draw your attention to certain specific elements of the impact of liberalisation on the economy as a whole. In an extraordinarily perceptive Statement, Mr. K. B. Dadiseth, the Chairman of Hindustan Lever Limited, has presented his vision for the year 2010, in a paper entitled "Liberalisation to Liberation"; I urge you to secure a copy. He points out that the future of Hindustan Lever is closely linked to the future of India and all of its peoples. He views, as we do at IIT, this exercise as one of partnership between industry and the Government, whereby we need to strive to transpose *liberalisation for some*, to *liberation for all*. He documents clearly that the aspiration of an 8% rate of economic growth *can* be attained, whereby within 15 years the quality of life for all Indians, in urban and rural sectors, can be improved dramatically.

A recent study, prepared by the consulting firm of McKinsey & Company with the CII, illustrates this thesis. It suggests that an integrated strategy be developed for companies and Government to help reduce the wastage (of up to 40% of production) in the food chain. This change would render it attractive to provide the USD 40 billion of investment needed to improve infrastructure in order to enhance output. India is the world's *third* largest food producer, but the combined turnover of our ten biggest food companies is *one-tenth* that of *one* European company's operations. Our food processing industry needs to grow rapidly if we are to fill our logical place in this sector. Another recent study (unpublished, from the NCAER) shows that the present consuming class in India reflects 29 million households, but that this number is expected to reach 91 million by the year 2006. This is an extraordinary rate of growth, reflecting an exceptional economic opportunity, for both domestic & international investors.

The financial services sector has undergone turbulent times of change in recent months, but is "growing-up" rapidly. As in many other developing economies, we have had our share of financial scandals, the most recent affecting the CRB Group. This turned out to be a total fiasco, where stable doors were bolted after not only the horse, but the entire herd had fled! We must learn from these problems and avoid the temptation to either run backwards or to bury our heads in the sand (a profile most commonly adopted by market participants!).

India's financial services sector *is* integrating with the rest of the world, and the issue of migrating progressively towards capital account convertibility (now addressed head-on by the Tarapore Committee Report) encourages a progressive and liberal viewpoint, suggesting that capital account convertibility *can* be attained within a three-year period. This will be difficult, *but is essential* if India is to join the world economic system.

MACRO-ECONOMIC NEEDS OF THE HOUR

The key economic problem, indeed the key social and democratic problem confronting India today is its population explosion. In order to stabilise the Indian population, the fertility rate has to be reduced to 2.1 children per woman, by the year 2016, which would cause the population to grow for a further 40 years, until it stabilises at 1.5 billion, in the year 2056. This enormous challenge can only be controlled through the provision of adequate educational resource, directed particularly towards primary education and female literacy. Linked to this population explosion is the difficulty of "jobless growth"; India will generate a population of 100 million *needing employment* by the end of this millennium. Indonesia reaped the benefit of investment in primary education within a short span of 20 years -- can we attain a matching success? We must now add a greater focus & thrust to primary, not only tertiary education.

We need to direct the benefits of liberalisation into the rural sector, which embraces 70% of the population, into *that* segment which *hears about* the benefits of liberalisation, but hardly *benefits from* this process of change. Again, for there to be real growth in the rural sector (as in all other sectors), significant infrastructure improvements are critical success factors. The relevance of the rural sector to our financial services industry is self-evident. As "well-being" spreads into this sector, the rate of savings should increase, the *recorded* savings-base should grow, and funds should be diverted into financial instruments. Hence, understanding the rural economy is of absolute essence in recognising how the financial services sector will grow in the years to come. The IIT Group will benefit from such growth, much of which will derive from these new rural consumers of such financial services, a market not effectively tapped today, except by Government-owned financial institutions, such as the LIC and the UTI.

Underlying any such trend, requiring the growth of confidence in the financial services sector, is a need for *quality competition*, an exposure to the global financial markets and constructive input from regulators. All these factors of change would generate enhanced confidence in the investing public, including potential rural investors of tomorrow.

There is no question that markets, especially free markets, need to be regulated. However, regulators should focus on the application of rational standards, and not seek *ex-post facto* scapegoats; they should seek to help the investing public learn lessons from past problems, which will build the enthusiasm of investors.

An integral element of global integration is the full convertibility of the Indian rupee on capital account. This requires significant preconditions, which are generally accepted as reasonable in a strong & stable economy; the fiscal deficit must be brought down to 3½%, and inflation should be brought down to 3%. Moreover, the non-performing assets of banks should be reduced to 5%. The need for full convertibility is accepted in principle, but the necessary preconditions represent a political minefield. Nevertheless, the progressive acceptance of capital account convertibility is an important ingredient in enhancing both international confidence in India's economy, as also the determination of our political leaders to *make* change happen. One of the present concerns of "India watchers" is that, if India wants to be part of the World Trade Organisation ("WTO"), restrictions on the free movement of capital could generate a medium-term invitation to be "kicked-out" of the WTO structure, especially where India does not suffer a severe balance of payments imbalance. Other aspects relating to the interface with the WTO include the need to remove both quantitative restrictions and import tariff barriers. If this is *not* done, Indian exporters (an essential engine of growth) will be significantly threatened by reactive measures from the rest of the free-trading world.

The present limited capital convertibility *does* provide for exporters to invest overseas. With significant foreign exchange reserves, there is a strong case for opening-up such investment opportunities also to *non-exporters*, for instance to strategically protect technology used by Indian companies, in India, through *Indian* direct investment. *This window of opportunity should be eased open*!

The financial services sector, *if* it is to flourish, needs free and open interaction with overseas institutions, banks, companies and individuals, representing the population of overseas investors considering India as a land of opportunity. These overseas investors should not be separated from their domestic counterparts through this artificial foreign exchange control barrier, necessary generations ago, but of limited relevance today. The bulk of the preconditions can be met through sensible, pragmatic government.

THE CRAWL TOWARDS FINANCIAL GLOBALISATION

Whereas much more needs to be done, Foreign Institutional Investors ("FII's") are already a power to be reckoned with in India's financial sector. The "arrival" of the FII community has changed the Indian financial scene for all time to come. Small players have been marginalised, and those that have escaped thus far know that they will be marginalised into extinction, sooner rather than later.

Today, the equity and working capital requirements of any financial services market participant have risen dramatically. The total capital requirements (and capital *adequacy* requirements imposed by the regulators) have increased beyond all proportion to the "good old days", and are *huge* compared to two years ago. Enhanced capital adequacy norms, uncomfortable for the entire industry, must be accepted as essential to protect investors, depositors and business partners.

A few years ago, our securities markets were dominated by the Indian institutional investors, who no longer account for a disproportionate volume of exchange activity. In spite of increased activity, the traded volumes have become fickle; securities markets participants can no longer be certain that a base business volume will be available "for all time to come". And as many investment decisions are now research-based, the *independence* of institutional investment decision-taking has changed substantially, for the better as far as the typical investor is concerned.

All significant Indian market participants need to reassess their strategies for the future and must seriously consider joining forces with globally active market participants, if they are to survive in a competitive, free trading environment. This applies equally to the IIT Group.

As equity markets develop, so debt markets must be helped to grow, for debt is a critical mechanism for financing investment in essential infrastructure. But FII's should be allowed to participate on equal terms, on a "level playing-field" (to use an expression favoured by Indian industry), if this market is to grow at the necessary rate. And with the growth in debt & equity markets, there is also a need to develop derivatives markets to provide the necessary economic protection to long-term investors, and a controllable vehicle for those who wish to speculate.

If India aspires to be a global market participant, its regulators have to apply international standards. And these standards relate not only to controls, but also to the raw material of any financial industry, namely accounting and reporting standards, which leave much to be desired in India. These standards *must* change; the IIT Group is involved with a think tank project in this regard.

As we crawl towards globalisation, we also crawl towards a dematerialised securities market. The rate of change toward the depository is still too slow – unless this industry *encourages* this change, it will take a generation before the market is substantially dematerialised. Many FII's are disappointed at the low rate of change, for a dematerialised scrip most certainly enjoys reduced transaction costs and greatly improved operating control over securities transactions. The IIT Group is an active depository participant (through IIT Corporate Services); we are clearly at the forefront of this process, as one of India's leading securities custodians for the domestic mutual fund industry.

We presently expect only 25 - 30% of outstanding shares, in most companies, to be dematerialised – those owned by institutional investors (including FII's). The remaining shares, owned by the promoters of a company or by the public, will probably continue to be held as physical scrip. These individual, "public" investors need to be educated on the benefits of dematerialisation; in this, the depositories need *much more* support from custodians & industry participants.

Many of the positive changes experienced in this "crawl" have been spearheaded and pushed for by the FII community, demonstrating unequivocally to the Indian markets that there is considerable merit in such global interaction.