Weekender
Your Think Tank for Investment Management
June 19th, 2007

## Special Economic Zone – Cluster of economic prosperity

Special Economic Zone (SEZ) is a very sensitive issue both from economic point of view and from political angle. A lot of discussions are going on in national media about the suitability and economic viability of the project. We believe, the benefits deriving out of SEZ overweighs the shortfalls and consider it as modern temple of economic prosperity. India would certainly benefit from increase in FDI (foreign direct investment), employment, exports and infrastructure development.

### Introduction

India was one of the first in Asia to recognize the effectiveness of the Export Processing Zone (EPZ) model in promoting exports, with Asia's first EPZ set up in Kandla in 1965. With a view to overcome the shortcomings experienced on account of the multiplicity of controls and clearances; absence of world-class infrastructure, and an unstable fiscal regime and with a view to attract larger foreign investments in India, the Special Economic Zones (SEZs) Policy was announced in April 2000. The Special Economic Zones Act, 2005, was passed by Parliament in May, 2005 which received Presidential assent on the 23rd of June, 2005.

SEZs are specially demarcated zones where units operate under a set of rules and regulations different from those applicable to other units in the country. The emphasis is on enhancing exports and creating an environment for attracting foreign direct investment (FDI) by offering tax sops. While units in the zone have to be net foreign-exchange earners, they are not subjected to any pre-determined value addition or minimum export performance requirements.

The SEZ Act 2005 came into effect on 10th February, 2006, providing for drastic simplification of procedures and for single window clearance on matters relating to central as well as state governments. The main objectives of the SEZ Act are:

(a) generation of additional economic activity
(b) promotion of exports of goods and services;
(c) promotion of investment from domestic and foreign sources;
(d) creation of employment opportunities;
(e) development of infrastructure facilities;

It is expected that this will trigger a large flow of foreign and domestic investment in SEZs, in infrastructure and productive capacity, leading to generation of additional economic activity and creation of employment opportunities.

The SEZ Rules provide for different minimum land requirement for different class of SEZs. Every SEZ is divided into a processing area where alone the SEZ units would come up and the non-processing area where the supporting infrastructure is to be created.

## Types of SEZ

| Type of SEZ | Minimum Requirements | Business Model |
|---|---|---|
| **Multi Product** | 1000 hectares of land, net worth of Rs 250 crore and investment of Rs 1000 crore | * Long gestation * High capital * High risk high return |
| **Sector Specific** | 10 hectares of land, net worth of Rs 50 crore | * Niche players with sector skills * Moderate returns |
| | and investment of Rs 250 crore | * Moderate capex and gestation |
| **IT / IT Services** | 10 hectares of land, net worth of Rs 100 crore and investment of Rs 250 crore | * Short gestation * Easy to sell * Low capital * Project could be funded through client advances * Moderate to high returns |
| **Captive SEZs** | 10 hectares of land, net worth of Rs 50 crore and investment of Rs 250 crore | * Companies masquerade new export-oriented factories as SEZs *Fiscal incentives justify new investments |

### LIFE CYCLE: SEZ

**Launch Phase**

**Project Highlights:**

- Huge Development Cost
- High discount initially to woo the customers
- Social Infrastructure is less developed at this stage.
- To show infrastructure on the ground to woo customers
- Expensive proposition to bring in co-developers at this stage

**Ramp-Up Phase**

**Project Highlights:**

- Additional Infrastructure to be added
- To build social infrastructure on a large scale
- Premium of land becomes higher
- Co-developers becomes interested in participating in development.

**Payback Phase**

**Project Highlights:**

- Prices of land shoot up on back of huge demand
- Brand recognition of SEZ
- More the land left, more will be the profits

**Annuity Phase**

**Project Highlights:**

- Sale & development is almost over
- Maintenance & administration is required

| Funding Raising | Funding Raising | Funding Raising | Funding Raising |
|---|---|---|---|
| • Mostly by Promoters through Equity<br>• Bank loans are tough to get<br>• Issue of Bonds<br>• ¼ of the project cost can be met through advances from prospective tenants | • Internal accruals start kicking in and help service debt<br>• Easier access to debt<br>• 20-30 percent cost can be brought by the co-developer<br>• Advances from the customers could fund 35-40 percent of the project<br>• Fund from OBU units becomes available. | • No debt or equity is required<br>• Big profits | • Needed will be met through accruals |

## SEZ DEVELOPMENT MODELS

| Industrial Parks | Fully Integrated | Outsourced Utility | Shared Infrastructure |
|---|---|---|---|
| • Basic Land and Industrial Infrastructure is provided by the developer, social infrastructure is very little on offer | • Everything from ports, airports, power plants, desalination plants, roads with social infrastructure such as Housing recreation, malls hotels, etc is provided by the developer | • Ports, airports, power plants, desalination plants, roads are outsourced by developers to co-developer on revenue sharing agreement | • A popular model in China where, few SEZ in the same vicinity come together and build and share infrastructure such as ports, airports, power plants, etc |

### Incentives and facilities offered to the SEZs

The incentives and facilities offered to the units in SEZs for attracting investments into the SEZs, including foreign investment include:-

- Duty free import/domestic procurement of goods for development, operation and maintenance of SEZ units
- 100% Income Tax exemption on export income for SEZ units under Section 10AA of the Income Tax Act for first 5 years, 50% for next 5 years thereafter and 50% of the ploughed back export profit for next 5 years.
- Exemption from minimum alternate tax under section 115JB of the Income Tax Act.
- External commercial borrowing by SEZ units upto US $ 500 million in a year without any maturity restriction through recognized banking channels.

- Exemption from Central Sales Tax.
- Exemption from Service Tax.
- Single window clearance for Central and State level approvals.
- Exemption from State sales tax and other levies as extended by the respective State Governments.

**The major incentives and facilities available to SEZ developers include:-**

- Exemption from customs/excise duties for development of SEZs for authorized operations approved by the Board of Approvals.
- Income Tax exemption on export income for a block of 10 years in 15 years under Section 80-IAB of the Income Tax Act.
- Exemption from minimum alternate tax (MAT)
- Exemption from dividend distribution tax
- Exemption from Central Sales Tax (CST).
- Exemption from Service Tax

**SEZ Approval Status**

| SEZ approval status | Definition | Number | Land Area(Sq Km) |
|---|---|---|---|
| Formally Approved SEZ | Formal approvals are given to those who have land to set up the SEZ. | 234 | 350 |
| In-Principle Approval SEZ | In-Principle approvals are given when the land has not yet been secured bur all other criteria are in place | 162 | 1400 |
| Notified SEZ | This is the final stage after which physical work can begin | 63 | 67 |
| **Total** | | | **1750** |
| | | Land Area (Km) | |
| India's total land area | | 2973190 | |
| India's total agri land area | | 1534166 | |
| **SEZ as % of agri land** | | **0.1%** | |

Source: Ministry of Commerce

**SEZs- leading to the growth of labour intensive manufacturing industry**

Out of the 234 formal approvals given till date, 80 approvals are for Textiles & Apparels, Leather Footwear, Automobile components, Engineering and other sector specific SEZs which would involve labour intensive manufacturing. The employment projected in the 63 SEZs notified so far is over 15,75,452 additional jobs SEZs are thus going to lead to creation of employment for large number of unemployed rural youth.

## Benefits derived from SEZs

Benefit derived from SEZs is evident from the investment, employment, exports and infrastructural developments additionally generated. Investment of the order of Rs.100,000 crore including FDI of US $ 5 - 6 billion is expected by the end of December 2007. 500,000 direct jobs are expected to be created by December 2007. The benefits derived from multiplier effect of the investments and additional economic activity in the SEZs and the employment generated thus will far outweigh the tax exemptions and the losses on account of land acquisition. Stability in fiscal concession is absolutely essential to ensure credibility of Government intensions.

**Exports from the functioning SEZs during the last three years are as under:**

| Year | Exports(Rs.Cr) | Growth Rate of exports |
|---|---|---|
| 2003-2004 | 13,854 | 39% |
| 2004-2005 | 18,314 | 32% |
| 2005-2006 | 22840 | 24.71% |

**Projected exports from all SEZs (82) for 2007-08: Rs. 67300 crore.**

Source: Ministry of Commerce

## Impact of the scheme

The overwhelming response to the SEZ scheme is evident from the flow of investment and creation of additional employment in the country. The SEZ scheme has generated tremendous response amongst the investors, both in India and abroad, which is evident from the list of Developers who have set up SEZs:

- Nokia SEZ in Tamil Nadu
- Quark City SEZ in Chandigarh
- Flextronics SEZ in Tamil Nadu
- Mahindra World City in Tamil Nadu
- Motorola, DELL and Foxconn
- Apache SEZ (Adidas Group) in Andhra Pradesh
- Divvy's Laboratories, Andhra Pradesh
- Rajiv Gandhi Technology Park, Chandigarh
- ETL Infrastructure IT SEZ, Chennai
- Hyderabad Gems Limited, Hyderabad

**Expected investment and employment from SEZs (by December 2009):**

- By the 63 notified Special Economic Zones:
  - Investment: Rs 53561 crore
  - Employment: 15,75,452 additional jobs

- If 234 formal approvals becomes operational:
  - Investment: Rs 3,00,000 crore
  - Employment: Rs 4 million additional jobs

**Commercial aspect of SEZ**

To understand an SEZ business, take the balance sheet of a realty company and merge it with that of a municipal corporation. Realty companies buy land, develop it and sell or lease it. Municipal Corporations provide infrastructure and utilities for a fee. An SEZ must do both. Initially, land lease will dominate revenues, but with time, utility, maintenance and administrative charges will account for la larger chunk. Beyond the 10th year, an SEZ balance sheet will be similar to that of a municipal corporation. However, many SEZ builders see this more as a grand realty development opportunity than as an infrastructure business- buy, build, sell. That model may bring profits in the short to medium but unlikely to help the nation's objectives of investment and export promotion.

**Amendments to SEZ Policy over the past year – steps in the right direction**

Amendments made over past one year in SEZ policy have addressed the concerns raised by different corners of the society and reaffirm Govt's view to develop SEZ as an infrastructure projects for promotion of investments, employment exports and not real estate.

**1) Land ceiling:** The upper limit of the area for multi-product SEZs has now been capped at 5000 hectares. However, state governments can prescribe a ceiling lower than 5000 hectares. In addition, there is also a cap of 12,500 hectares for a single applicant. While this could impact the mega SEZ plans of Reliance, DLF, Omaxe, Unitech etc, it is reported that companies are looking at options such as splitting the SEZs to comply with the new rules3

**2) Processing Area:** The minimum processing area has been uniformly raised to 50% for all SEZs. Earlier, the minimum processing area was 35% for multiproduct SEZs and 50% for sector-specific SEZs. This could adversely impact developers who initially intended to use 65% of the SEZ land to build hotels, malls, schools and entertainment centres.

**3) Land acquisition and rehabilitation:** The onus of land acquisition will now fall on the private sector as compared to the earlier rules where states could acquire land. This is positive as in some cases; state government's powers were being mis-used. More-over the new rules will shield the land-owners from the states who had the power to forcibly acquire land for public use under the land acquisition Act.

**4)** Companies operating in SEZs would have to make **fresh investments** in plant and machinery

**5)** Companies that **import for the purpose of re-export would get tax breaks** while those sourcing from domestic tariff areas would not.

**6)** Earlier the SEZ developer was permitted to allot land to anyone in the non-processing area for business and social purposes. These rules were changed so **that vacant land can be leased only to a co-developer approved by the authorities.**

**7)** The RBI issued a directive that said all loans given towards setting up SEZs will be treated in the same manner as exposure to commercial real estate, the stock market, and venture capital. This implies higher provisioning norms (100bps as against 40bps for standard loans) as well as higher risk weights (150% instead of 100% for standard loans). **Higher capital requirements are yet another way of curtailing fly-by-night SEZs mushrooming over the country, and help retain only the more serious players.**

**8) Rules regarding minimum investment and net worth have also been amended**, with promoters in multi-product SEZ's required to have a net worth of Rs2.5bn and a minimum investment of Rs10bn. (Sector specific Net Worth=Rs0.5bn and minimum investment =Rs2.5bn).

**9)** In contrast to the earlier rules where units had to be net forex earners over the first five years to get SEZ benefits, under the new rules **export earnings from SEZs will now have to be equivalent to their purchases from domestic areas.**

**Conclusion**

The concept of SEZs in India has been subject to much controversy and debate over the past year. Although Indian SEZs are much smaller in scale than their Chinese counterparts, we think they are a step in the right direction. While norms may have to be further tightened to prevent leakages, the government's thrust on SEZs coupled with private sector participation is likely to promote industrial activity. Further, estimates by the Ministry suggest that SEZs will bring in investments to the tune of Rs1000bn by the end of Dec07, creating 500,000 direct jobs. Net-net, we believe the benefits that will accrue in terms of infrastructure, trade, employment, and investment will offset the teething problems that SEZs have encountered so far.

**Note:- To get daily Technical, Fundamental recommendation Online Subscribe to KRC Earning Ideas to Make your Money work for you.**

---

KRChoksey

Kisan Ratilal Choksey Shares and Securities Pvt. Ltd.
1102, Stock Exchange Tower, Dalal Street, Mumbai 400 001. Phone : 91-22-56338050 Fax : 5633 8060

Members: BSE & NSE
www.krchoksey.com