A growth story

As India Inc's appetite for foreign assets has grown, so market liberalisation and reform in FDI policy have ensured fewer challenges remain for inbound investors. Manjula Chawla, Ritika Ganju and Yamini Roy, of *Phoenix Legal*, examine some key trends and legislation.

Recent trends

Since the liberalisation of its economy in 1991, India has enjoyed robust and continuous growth in inward investments. But lately, much has been talked about the substantial potential of India to contribute towards global outward foreign direct investment (FDI). According to a Columbia University report last year, India has emerged as the world's 21st largest outbound investor, with overseas investments climbing over US$75 billion in the past decade. Annual FDI outflow from India has jumped fifty-fold since 2000.

Deal statistics reveal that outbound deals have become progressively larger in terms of volume and value as and have given domestic deals a run for their money. It is rightly said that despite the huge potential of the economies of the BRIC nations, they are not absolutely immune to the effects of the financial crisis, and sure enough the durability of India's M&A market was put to the test with the onset of the global meltdown. Though outbound deals experienced a setback in 2008 and 2009, it was short lived. According to Dealtracker, a Grant Thornton publication, the number of outbound deals plummeted to 82 in 2009, from a high of 243 (India's annual record figure), and the value of deals dived to US$1.38 bn from US$32.76 bn in 2007. But India, aiming to become the fastest growing economy in the world, successfully combated the crisis with its appetite for foreign businesses, and the number of outbound deals surged back to 198 in 2010 with deal values accounting for 45 percent of total M&A in 2010, up from 12 percent in 2009. With deal values rising to more than 16 times those of 2009 there are whispers of an emerging economic order, and the bets are on India.

Geographic and sectoral targets

For the last few years, all big ticket acquisition deals by Indian businesses were targeted in the first world and not much was invested in fellow developing countries. Until 2009, the United States was the top destination for acquisitions in terms of volume, while the United Kingdom was leading the race in terms of value yielded by such deals. However, the financial gloom seems to have set India's acquisitions on a pathway towards the emerging economies such as Africa and Asian countries. In fact, the World Bank has reported that with the sharp decline in outward FDI flows from developed countries since the crisis, the importance of investment from other developing countries (South-South FDI) increased and accounted for an estimated 34 percent in 2010 compared to 25 percent in 2007. The acquisition by India's telecom major, Bharti Airtel, of Africa's Zain, worth US$10.7 bn was the largest South-South M&A deal of 2010.

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The activity of India's outbound deals has been spread across a wide spectrum of sectors. In the last decade, the Indian IT industry – large, yet still growing – has made its mark the world over and has been hitting the business news headlines for acquiring IT and BPO companies in all corners of the globe. According to a survey report published by Mape Advisory Group, an Indian investment banking firm, the software and BPO industry saw the largest deal count and was usually at the top for annual deal counts between January 2000 and March 2006. The IT industry was active even at the time of peak recession and accounted for 102 outbound deals in 2008. The next big revolution in India after IT has been telecom. With the growth of the telecom industry came the need to embrace technology and investment from abroad, and so the sector led total M&A deals in 2009 and 2010 in terms of value. The telecom sector embarked upon outbound deals in a big way in 2010 with the Bharti-Zain deal, the largest of 2010. Other telecom deals in 2010 such as Bharti Airtel's acquisition of Warid Telecom International Limited and Telecom Seychelles also indicate the growing zeal of the Indian telecom sector to expand abroad. Interestingly, the growing numbers of young telecom companies, which have received massive FDI doses in the recent past also demonstrated an inclination to expand and get access to new markets by acquiring businesses abroad. The second major outbound deal player in 2010 was the banking and finance sector, which secured the second largest deal in terms of value with Hinduja Group's acquisition of Belgium's KBL European Private Bankers for US$ 1.8 bn.

The other major market players have been the metal, mining, automotive and pharmaceutical sectors. The deal value record set by the metal industry in 2007 with the mega deal of Tata Steel's acquisition of Corus Group, the Anglo Dutch steelmaker, is yet to be beaten. With the surge in demand for infrastructural facilities over the last few years, it was almost inevitable that the metal industry would grow – the super-size deals like Tata Steel's acquisition of Corus, Aditya Birla's group Hindalco's acquisition of Novelis Inc., a Canadian company for US$ 6 bn in 2007 and recently, Hindustan Zinc Ltd.'s acquisition of Anglo American Plc's Zinc business for nearly US$ 1.3 bn in 2010, helped the sector to grow even more. India's mining sector has been catching up with the growing economy and is expected to be leading the outbound M&A field along with the natural resources (including oil and gas) business. The biggest deal in the mining sector was the acquisition of Australia's Griffin Coal by Lanco Infratech Ltd. for US$ 845 mn, followed by Essar Minerals Resources Limited's acquisition of Trinity Coal Corporation LLC, a US company for US$ 600 mn. There has been no looking back by the automotive industry after the much-publicised acquisition of Ford's Jaguar and Land Rover by Tata Motors in 2008, when such giant deals were rare news as the strongest economies of the world grappled with the financial crunch. More recently, Mahindra & Mahindra acquired a

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70 percent controlling stake in Ssangyong Motor Company, a South Korean auto maker, for US$ 463 mn. The sheer number of outbound acquisitions completed by Indian pharmaceutical companies amidst the global recession grabbed the attention of global M&A experts. With Fortis Healthcare Ltd's acquisition of Parkway Holdings Ltd. for nearly US$ 685 mn, 2010 saw one of the largest deals in this sector.

An interesting trend is that the players in India Inc.'s venture to expand abroad are no longer limited to the super-size family owned businesses and prominent business tycoons such as Tata, Birla and Reliance groups. Rapid economic growth and development has given young businesses an opportunity to grow and enough confidence to expand outside the Indian jurisdiction - Lanco Infratech's acquisition of Griffin Coal featuring in the top 10 outbound deals of 2010 would be a good example to mention here. Another interesting fact is that, unlike the 2005–2008 period when a number of Indian companies had taken their first steps towards acquisitions abroad, most Indian companies are now more experienced in dealing with global M&A markets and undoubtedly are more confident in dealing with their western counterparts – even though in most of the cases their counterparts are much bigger in size and experience.

Financing outbound deals

With cash rich Indian companies and high liquidity in the domestic banking sector, India Inc.'s appetite for foreign assets and businesses did not waver especially when the economic downturn presented numerous opportunities for distress sales abroad at attractive values. Until very recently, most of the large outbound deals were funded through leverage buyouts, which effectively reduced the risk on the domestic balance sheets of the Indian companies. M&A bankers have often explained that the structure of financing for outbound deals varies with the status of financial markets and the destination of acquisition. Precisely, if assets are acquired in developed countries such as the UK and US, a substantial part of the financing is generally non-recourse, as financers place their reliance on the cash generating capacity of the target. On the other hand, if assets are being acquired in emerging markets such as Africa, focus would be on the cash flows of the Indian parent much more than the cash generating capacity of the target.

Post financial slowdown, the role of Indian lenders vis-a-vis their international counterparts in India's outbound deals has been a topic of discussions amongst M&A experts and bankers. International Financing Review (IFR) India Special Report 2010, a Thomson Reuter publication, reports that India's rupee loan markets are used to playing second fiddle to their offshore counterparts, especially when it comes to high-profile international acquisitions. But domestic lenders are catching up fast. The Bharti-Zain deal worth US$ 7.5 bn set a good example for aspiring acquirers to follow. While the offshore loan financing backing the acquisition comprised nearly US$ 7.5 bn, a rupee loan financing of the remaining US$ 1.5- 2 bn came as a domestic support. IFR reports that US$ 7.5 bn financing in the offshore market is already quite large, and had the rupee financing plan not been in place, it would have been more challenging for Bharti to fund the acquisition.

It is believed by market experts that while offshore financing may continue to support big ticket M&A, a trend is emerging for domestic lenders to participate in outbound acquisitions targeted by mid and small cap Indian companies. One of the 2010 deal chart toppers - Indian healthcare service provider Fortis Healthcare's acquisition of Singapore listed Parkway Holdings was financed by Axis Bank, a

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domestic lender, by way of a 12 month bridge financing backing its US$ 3.2 mn bid.

Regulatory regime for going abroad

If the steady inflow from their foreign counterparts has increased the liquidity in the hands of seasoned entrepreneurs, government policies and the extant regulations have had their role to play in this growth story. The Indian legal system has encouraged and moulded investment structures adopted by businessmen looking outside when investing. There is, however, a fair distance to travel. Some of the regulations that have shaped the nature of outbound M&A are the regulations framed by the Reserve Bank of India under the *Foreign Exchange Management Act,* 1999 on Overseas Direct Investment (ODI). The Bank has, through this set of regulations, constantly tapped the pulse and the appetite of the domestic entrepreneurs in volumes of investment abroad, and provided them progressively increasing caps. Initially, in 2004, investments of up to 100 percent of the net worth of the Indian parent were permitted by the Bank. This was later increased to 300 percent and then to 400 percent.

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The growth in outbound M&A deals has been aided by the good track record of Indian companies in integrating overseas acquisitions, a friendly regulatory environment and reformed corporate governance. Indian buyers are readily accepted in the international markets today due to the confidence-building measures taken by the Indian regulators. Constant endeavour to implement corporate governance reforms have created the appropriate platform for them to be significant players in global M&A.

Indian inbound M&A: potential challenges for foreign investors

Post-recession, inbound M&A activity has experienced an upswing, with 2010 yielding a total of 91 inbound deals generating a total value of US$8.96 bn. With liberalisation in the Indian markets and constant reform in FDI policy, fewer challenges remain as a concern for the foreign investor. Indian FDI policy has become extremely foreign investor friendly, but still certain sectors remain capped and require prior approval of the government for investment. Such sectors include single brand retail, insurance and defence. Obtaining the necessary approval may cause delays.

The structuring of FDI transactions is restricted due to the kinds of instruments that may be involved. Under the Reserve Bank of India regulations, only equity shares, compulsorily convertible preference shares or debentures can be issued against FDI and any other form of shares or issue of debenture is treated as an external commercial borrowing (ECB) and would be regulated in accordance with the ECB guidelines issued by the Reserve Bank of India. Along with the aforesaid shares or debentures which are treated as ECB, loans brought in by foreign investors from abroad are also treated as ECB. This may pose a problem as ECBs cannot be used for working capital requirements or re-payment of existing Rupee loans.

Another potential challenge at the negotiation table is posed by the transfer pricing regulations of the Reserve Bank of India. In case of an unlisted company, the price for transfer of shares from an Indian resident to a foreign investor cannot to be less than the fair value to be determined as per a discounted free cash flow method. However, in the case of transfer of shares from a foreign investor to an Indian resident, the minimum price as prescribed for transfer of shares from an Indian resident to a foreign investor can be the maximum transfer price.

Lastly, the merger control provisions under the *Competition Act*, 2002, which have become effective since June 2011, require compulsory notification and clearance from the regulator for 'combinations' which breach the thresholds provided under the Act. This may result in stalling or delaying the investment for a period of seven months, which may prove to be a potential roadblock for investors looking to infuse quick money into the market. However, the prescribed thresholds are high, and with exemptions granted for a period of five years in certain cases, only a limited number of transactions would be affected.

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