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Investment opportunities in India's M&A market

Legal and policy reforms have taken hold of India, thanks to a stable government and a focus on economic growth.

Since the early 1990s, foreign investment policies have been progressively liberalised, irrespective of the political leadership, contributing to the growing global interest in the Indian market. The process is not complete and many restrictions remain but a distinct pattern of liberalisation is emerging with the introduction of new and more structured policy statements.

The government of India recently issued a consolidated policy statement on foreign investment and the Reserve Bank of India (RBI) does the same every year. It is significant that such a basic minimum level of clarity on government policies is greeted as a welcome sign of the Indian government's growing maturity and its appreciation of the business community's concerns.

However, foreign investment limits remain in place in critical industrial sectors such as insurance, telecommunication services and defence production, and foreign retailers are still prohibited from multi-brand selling. Overseas borrowings by Indian entities continue to be strictly regulated. Restrictions also remain on the use of borrowings (both domestic and overseas) for the purpose of financing domestic acquisitions. We see this as a potential constraint on the growth of mergers and acquisitions (M&A) in India.

Key features of India's M&A market

The dominant feature of the Indian M&A market since the early years of economic liberalisation has been the high level of activity that has been generated by foreign investments into India. Capital has typically been in short supply for Indian businesses. It was this issue, coupled with high interest rates for domestic borrowings, a restricted regime for borrowings from outside the country and a relatively shallow domestic capital market that led to the foreign bias in M&A activity.

Since the global financial crisis, a drop in the amount of investment coming into the country has created opportunities for domestic M&A.

India's M&A market today represents a mixed bag of joint ventures (JVs) between Indian and foreign businesses, outright acquisitions by domestic and foreign players and a relatively modest number of private investment in public equity (PIPE) transactions.

Most foreign companies view India as a substantial consumer market in its own right. This differs from the view of China, the other major Asian economy, as a manufacturing powerhouse which has factories that turn out products for global consumption.

However, India is not primarily a market for foreign goods. It is a market for products that have been customised for India's consumers. Take the example of Maruti Suzuki, which largely defined the market for small indigenous cars in India. Around 25 years ago the parent company, Suzuki, saw an opportunity to customise one of its products for India and the Maruti car was born.

The Maruti proved so successful that, at one point in the 1990s, the Maruti 800 had a 60 per cent share of its market segment in India and its sales outstripped Suzuki cars of that class throughout the rest of the world.

Options for investing in India

A conscious effort on India's part to make itself more attractive to foreign investors through careful and deliberate liberalisation has led more companies to consider following the Maruti Suzuki example.

One of these is a company from the USA which is active in the construction and the agricultural equipment sectors. The company decided to set up a green-field venture in India to manufacture a product that was similar to one which it sold in the USA but had been specifically tailored and redesigned for India's domestic market.

Like all inward investors, the company had to choose whether to build or to buy: to

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enter the market by acquisition or by building from scratch. Each approach has its advantages and disadvantages.

Buying has the advantage of giving the foreign entity a head start in the market. Unfortunately, the opportunities to buy are limited owing to the relative scarcity of appropriate target companies which an international company can acquire outright. Those that may be attractive will often need to be disengaged from a conglomerate structure.

Foreign buyers may also find unrealistically high value expectations among Indian vendors because they tend to benchmark their companies against the value of similar listed enterprises currently riding high in an overheated market. This issue is one of the reasons for the relative abundance of foreign/domestic JVs in India.

Buying a company that is listed on one of the Indian stock exchanges with the aim of taking it private is next to impossible. Under Indian takeover law, a tender offer has to be made but experience suggests a holding of 35 per cent to 75 per cent is all that can be expected from such an offer. While such a result is suitable for financial institutions and private equity players, it deters strategic corporate investors. Leveraged buyouts are also not a part of the Indian M&A landscape owing to regulatory restrictions on the use of borrowed funds for acquiring shares of Indian companies.

Indian business owners who are in a position to sell to a foreign investor will often adopt a hedging strategy to maximise their profit. Rather than selling their business outright, they will sell a part of it initially and look to sell the remainder in due course – after the new partner has increased the company's value through investment, technology transfer, international exposure and management expertise – at a price which is commensurate with the company's new, higher value.

That approach is not wholly one-sided. The Indian business owner will provide 'indifferent services' to help the overseas investor become comfortable in the Indian environment. For many, it is a worthwhile trade-off. The Tata-IBM and Ford New Holland-Escorts tie-ups are cases in point.

Partnering with Indian companies

Foreign ownership is restricted in several key sectors, such as telecommunications and broadcasting. In such restricted sectors 100 per cent foreign ownership of companies is not allowed. Instead, we see foreign investors partnering with Indian companies that can add value to the relationship, for example, by providing a distribution channel.

Whether companies plan to operate in a controlled sector or not, many of them have found that building either a green-field venture from the ground up, or a brown-field venture is a practical option for developing a viable business in India. GE is an example of a company that has adopted such an approach. It manufactures a wide range of products in India, from motors to light bulbs, and is also active in healthcare and financial services. It has become one of the most respected businesses in the country without having Indian partners.

GE and other long established multinationals such as Bayer Healthcare, ABB, Nestle and Unilever have found that their Indian operations assimilate their corporate *modus operandi* easily. The Indian culture is very adaptive, which makes it easy to place Indian managers in key roles with confidence. There is no shortage of Indian executives with experience in both overseas and home markets.

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The legal system in India

One major factor in India's favour is its common law system. In corporate jurisprudence, civil and contract law, it mirrors the English legal system to such an extent that anyone familiar with British and Commonwealth regimes, and to an extent even that of the USA, will find the corporate law environment familiar. Essential doctrines of English law that govern companies – for example, directors' responsibilities and fiduciary obligations, shareholder rights, powers of the board, how offences against the company are judged and how the regulator takes a view – govern Indian companies as well.

Indian law is predictable. All laws, superior court judgements and proceedings are conducted in English, and not in the vernacular. Further, the separation of power between the legislature, executive and judiciary is clearly demarcated, widely known and easily ascertainable.

A potential obstacle posed by India's legal system is that court proceedings can be lengthy. Recent proposals to address this issue include the creation of commercial courts, i.e. a special division within the High Courts to fast-track commercial disputes that are assessed above a specified value. Implementation of this proposal may help to provide speedier resolution of large commercial disputes between companies.

Importance of family ties in business

The predominant factors that set India apart are cultural. Foreign investors will become aware of these differences as soon as they start negotiating an agreement with an Indian counterparty.

To understand how traditional Indian businesses operate, one has to have a working knowledge of the underlying cultural values. Families and family ties have a marked importance in the Indian business environment. This makes negotiating with a family-owned private business very different to the same discussion with a similar sized Western enterprise with its professional ownership and management and widely dispersed shareholders.

In the case of most Western jurisdictions, the corporate governance norms seek to balance the interests of directors and shareholders in running the company. For most companies that are owned by private equity houses, the endgame is to sell the company to the next buyer at a profit. In pursuit of that objective, they will ensure the balance sheet looks attractive and that the operation is lean but adequately staffed.

By contrast, most Indian businesses are owned by a 'promoter' family which has a significant say in the governance of the company. Business decisions can be influenced by emotional considerations, such as keeping control within the family, a promoter's personal legacy and jobs for family members. With no distinct separation between ownership and management, the company is run very much in accordance with the wishes of the promoters. But this kind of personal attachment also means the promoter will stand behind a company in times of distress. Lenders and institutional investors recognise the value of this type of personal support and place a fair degree of significance on the role of the promoters.

This is also a vital reason why hostile takeovers do not usually work in India. Institutional investors generally see promoters as the best caretakers of the company and are uncomfortable with them being 'pushed out' by outsiders because this may disturb the equilibrium of the business.

However, there is a good reason for maintaining a clear divide between ownership and management in globalised business. Without this separation, corruption has a chance to breed. The foremost recent example of how things can go wrong is Satyam, a listed information technology (IT) services consultancy, which suffered a major scandal involving the role of its founding promoter two years ago.

Although it was listed on New York and Indian stock exchanges and met the strict criteria imposed by them, the company's founder-promoter was able to falsify its balance sheet. The auditors, who were implicated, are now imprisoned while the investigation continues. The Indian government was forced to step in to minimise the social and economic impact of the scandal and the company had to be sold off though a process managed by its new board of directors who were appointed by the Indian government.

Role of the promoter shareholder in unlisted companies

Unlisted Indian companies tend to be run almost as the personal fiefdom of the promoter shareholder, who, when negotiating a buyout, will want continuity, board control, family representatives on the board and the main committees, and a guarantee on succession planning. Foreign investors need to be open to these ideas to pursue a successful buyout negotiation.

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These considerations have also influenced company law in India. In a notable divergence from Western law, Indian law has been developed to protect non-promoter shareholders. Where in the West, corporate governance aims to protect diversified shareholders from self-serving directors and management, Indian law focuses on protecting the interests of the minority shareholders from the promoter group. On the positive side, the role of promoters has helped many Indian companies to survive the financial crisis without going into insolvency. On the negative side, the minority shareholders may often feel helpless against the way in which the promoters run companies.

In our view, foreign investors should be confident that the Indian government will continue its programme of liberalisation. It is a sign of the growing maturity of the market that no decisions on opening sectors to foreign investment have been reversed, except in the case of tobacco. The government continues to deliberate on this matter but, to date, decisions have only gone in favour of foreign investors.

India has also signalled an end to the practice of obtaining consent from the original Indian partners before a foreign investor is allowed to end a JV either to go it alone, or to change its Indian partners. We believe that this move illustrates the proactive approach adopted by the authorities to encourage investment. India cannot afford to be seen as being protectionist.

Markets need participation

India's capital market has grown by 100 per cent in the last 18 months. This is phenomenal growth by any measure. But it is a cause for worry in its own right. More paper in the market will have an automatic corrective influence and will help to deepen the market. We believe the recent announcement by the government to raise the threshold for public shareholding in listed companies to 25 per cent may also help to address this issue.

The financial markets of developing countries such as India need public participation. Without it, they become capital deficient countries. But since there is usually a shortage of money domestically, there is also a need for foreign investment.

The 'take-private rules' in India make it difficult – and potentially unviable – for a listed company to be delisted from stock exchanges. This is a dampener on private equity led M&A activity. Experience shows that an open offer on a listed company might gain 40 per cent to 60 per cent but not much more. It is economically challenging to reach a stake sufficient to take a company private but almost impossible to squeeze out the minority. In addition, price discovery via the reverse book building process allows even a handful of shareholders to bid at impossibly high prices and skew the process.

Similarly, the absence of a single super-financial controller in India creates instances of overlapping jurisdictions. Recently, in the case of Unit Linked Insurance Policies, there has been an apparent overlap of jurisdictions between IRDA which is the insurance-sector regulator and SEBI, which is the regulator for, *inter alia*, mutual funds. As both regulators are independent, approval from one organisation is not binding on the other. However, this issue does not in itself suggest that a single-

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regulator system is better than a multi-regulator one.

The way ahead

Investors who have been prepared to take Indian sensitivities into account have achieved notable M&A successes, for example, through strategic investment in telecommunications and, from a private equity perspective, in real estate, construction and property development. We see considerable interest also among companies in the healthcare sector.

In addition, there is a significant amount of interest – and not just from international investors – in broadening and deepening India's regulated financial services sector. International banks would like to see more banking licences issued, and because banking is a restricted sector for Indians as well, domestic players are likely to support such a goal.

Clearly, there is more that needs to be done before India is completely liberalised. However, we believe India offers a unique opportunity for foreign investors who are prepared to adopt a proactive approach by undertaking preliminary research to build up an accurate picture of the country's potential, giving due consideration to operating strategies that are tailored to its economy, as well as understanding the cultural differences between India and the West.

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