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MERGERS & ACQUISITIONS AND FDI IN INDIA: AN ASSESSMENT

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ABSTRACT:

At the outset, it is necessary to define Foreign Direct Investment and distinguish it from Foreign Portfolio Investment. Two key elements need to be emphasized in the definition of Foreign Direct Investment. FDI can be defined as an investment made by a resident of one economy in another economy, and it is of a long term nature or of 'lasting interests'. The investor has a significant degree of influence on the management of the enterprise.

Although everything seems hunky dory at the pace at which Indian companies are striking cross-border mergers and acquisitions deals, the road may be riddled with challenges in matters relating to cultural differences, corporate governance, competition law, legal risk, etc. Indian companies are not yet accustomed to operating in an environment where there is a strong competition regulator.

KEYWORDS: *FDI, Mergers and Acquisitions, Indian companies.*

INTRODUCTION :

At the outset, it is necessary to define Foreign Direct Investment and distinguish it from Foreign Portfolio Investment. Two key elements need to be emphasized in the definition of Foreign Direct Investment. First, FDI can be defined as an investment made by a resident of one economy in another economy, and it is of a long term nature or of 'lasting interests'. Second, the investor has a significant degree of influence on the management of the enterprise.

FDI is a category of investment that reflects the objective by a resident enterprise in one economy [direct investor] of establishing a lasting interesting an enterprise that is resident in an economy other than that of the direct investor. Lasting interest implies the existence of a long term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of that enterprise.

It is not always necessary that the investor must own more than 50% or more of voting power of an enterprise. At the operational level, ownership of even 10% or more voting power of an enterprise comprises relatively sizeable and significant investments in the enterprise. These investments are large enough for the investor to have a role in the management of the associate companies and hence can be classified as Foreign Direct Investment rather than Foreign Portfolio Investment. Therefore, IMF defines FDI, for operational purposes, in terms of 10% of the voting shares or voting power is the level of ownership necessary for direct investment interest to exist.

Foreign Portfolio Investment basically involves buying a share or security of any entity. It can be considered as merely an investment in a piece of paper i.e. share certificate and this form of investment can be easily liquidated. Foreign Direct Investment, on the other hand, involves more than just purchase of securities. It concerns the amount of

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financing provided by a foreign owner who also becomes directly involved in the management of the enterprise by owning more than 10% of equity shares of a company. The direct investor is considered to be more of an owner/manager than an investor/lender.

Although, Foreign Portfolio Investment can also be a long-term investment, like Foreign Direct Investment, there is a considerable difference in the perspective and outlook between the two. Portfolio investments in the securities of a foreign enterprise tend to be held for two or three years. But it is considered to be just that: a holding of shares that can be easily sold in the stock market at any time. Foreign Direct Investment, however, is considered to be investment in nuts and bolts in the foreign country. It is not viewed as a holding of shares of a foreign enterprise but an investment in the fixed assets, personnel and management of the enterprise. The portfolio investor is a holder of shares amounting to less than 10% of equity of an enterprise in a foreign country, whereas a director investor either wholly or partly owns an enterprise domiciled in a foreign country. The direct investor views investment as ownership of the company's property, plants and equipment rather than that of equity and debt securities.

The transformation of Indian companies from domestic to global players went through three phases

Phase-I [1947-1991] Pre-reform phase:

On the eve of independence in 1947, India inherited an economy that was one of the most underdeveloped and poorest in the world. Jawaharlal Nehru adopted mixed economy with emphasis on socialist pattern of society and central planning. It created a 'License Raj'. Companies needed licenses for everything. Licenses were very difficult to obtain. Only those with political connection or the ability to pay bribe could get it. It created a protected market for license holders with practically no competition either from domestic or global players. In 1973, Foreign Exchange Regulation Act forced foreign companies to dilute their shareholding to less than 40%. Most foreign companies were not interested in minority shareholding and preferred to exit. The position of Indian business houses was further strengthened. The prevailing government policies encouraged family ownership of Indian business assets. Indian business was dominated by established business groups controlled by powerful families. The production controls one hand and growing population on the other, lead to chronic shortages in the economy.

The highly favourable climate for large Indian business houses and the resulting strong monopolistic positions made them more prone to stay at home in the sheltered domestic market. There was acute shortage of foreign exchange. The Reserve Bank of India controlled foreign exchange under the Foreign Exchange Regulation Act, 1973. If an Indian businessman wished to travel abroad, he could get only $8 per day! Foreign capital was in such short supply that the question of overseas acquisition by Indian firms never ever arose. Until 1991 every thing was loaded against Indian firms with global aspirations. Indian companies were not in a position to compete in global markets or even at home against global competitors.

Phase-II [1991-2000]: Corporate restructuring phase: economy becoming globally competitive:

The post-1991 reforms changed the environment for Indian business. To begin with, License Raj was dismantled. Liberalization of industrial licensing meant emergence of new domestic competitors. As a result, Indian companies went through a tough corporate restructuring program to enhance domestic competitiveness. Similarly, reduction of import tariffs and entry barriers for foreign firms opened up Indian economy for foreign players. This forced even Indian firms with no global ambitions to become globally competitive to survive this foreign competition. The highly diversified Indian business groups realized that they needed to focus on a few industries where they could obtain leading domestic positions. After becoming number one or two in their respective fields, they started aspiring for global ranking. Slowly but surely, Indian companies began benchmarking themselves against world competitors. It was a first step towards global ambitions of Indian firms.

The family owned and managed firms realized the importance of professionalism in management. They began to scour the Indian subsidiaries of Multinational companies for management talent. Professional management is a crucial factor in making Indian companies globally competitive. Corporate restructuring brought confidence to Indian business. Indian companies transformed themselves from domestic players, scared of global competitors and constantly seeking government protection in domestic market, into confident players capable of building Indian multinationals. Those who resisted the process of globalization became active promoters of globalization. They not only welcome the government policies toward a more open economy but also started putting pressure for more and quicker reforms.

Newly globalizing companies had to face all kinds of doubts regard their capabilities. India's image in the world market was the biggest obstacle. India was seen as a land of snake charmers, historical palaces, temples and holy men. In the minds of most citizens of developed countries, India still conjures up the image of exotic land, customs and mass poverty. This image of historical India or exotic India may be good for attracting foreign tourists; it becomes an obstacle in the internationalization of Indian firms.

It was extremely difficult to convince global customers that Indian supplier could be reliable source of good quality products produced by a technologically sophisticated company. It took Bharat Forge seven years to find its first customer. Mind-set barrier was to be overcome. It required persistence in the face of initial setbacks on the way to globalization. 'Made-in-India' tag was a liability and it required a leap of faith to make it an asset. Becoming a global corporation is a process of learning from your own mistakes and other peoples mistakes. There are bound to be some initial setbacks.

Phase-III [2001 onwards]: Aggressive takeovers:

The replacement of Foreign Exchange Regulation Act, 1973 by Foreign Exchange Management Act in 1999 and subsequent liberalization of capital account of the Balance of Payments brought about significant liberalization in government policy regarding availability and use of foreign exchange[5]. The Reserve Bank of India was designated as the nodal agency for administration of the policy, which had earlier been entrusted to the Ministry of Commerce, Government of India. Indian investment abroad is governed by Foreign Exchange Management [Transfer and issue of any foreign security] Regulations 2000 notified by the Reserve Bank of India from time to time. The limit for investment up to U.S.$ 50 million which was earlier available in a block of 3 years was made available annually without any profitability condition. Companies were allowed to invest 100% of the proceeds of their A.D.R/G.D.R. issues for acquisition of foreign companies and direct investment in joint ventures and wholly owned subsidiaries.

Automatic route was further liberalized in March 2002 wherein Indian firms investing in joint ventures/wholly owned subsidiaries outside India were permitted to invest an amount not exceeding U.S. $ 100 million as against the earlier limit of U.S. $ 50 million in a financial year. In March, 2005 Automatic Route was significantly liberalized to enable Indian firms to fund to the extent of 200% of their net worth in a single year. No prior approval of R.B.I. is now required for opening offices abroad.

With a view to enabling India Corporate entities to become global players by facilitating their overseas direct investment, the permitted end-use of External Commercial Borrowing was enlarged to include overseas direct investment in joint ventures/wholly owned subsidiaries including Mergers and Acquisitions abroad by harnessing resources at globally competitive rates. In 2007, in limit of 200% of the net worth under Automatic route was enlarged to 300% of the net worth in a single year. Furthermore, Indian Venture Capital Funds [V.C.Fs] registered with S.E.B.I. are permitted to invest in equity and equity-linked instruments of off-shore venture capital undertakings subject to an overall limit of U.S.$ 500 million and compliance with the S.E.B.I. regulations issued in this regard.

REVIEW OF LITERATURE:

Determinants of Acquisitions: Trahan (1993) identified five primary financial characteristics that motivate firms to make acquisitions namely i) debt capacity – measured by debt equity ratio and debt service coverage ratio, ii) firm size – measured by total sales, iii) management performance – measured by total stock market returns and dividend, return on equity and asset turnover ratio over a two year period, iv) free cash flows – dividend payout ratio and new investments as a ratio to total assets, here they expect that firms growing through internal investments may not make acquisitions v) growth ratio – low growth firms may seek to grow through an acquisition. Haleblian, J.et.al. (2009) in their review of literature on mergers and acquisitions have identified value creation, managerial self-interest, environmental factors, and firm characteristics as the main reasons that firms make acquisitions. Huyghebaert & Luypaert (2010) study the antecedents of acquisitions for Belgian firms including firm characteristics, industry and financial market variables. They study characteristics that prompt firms to undertake acquisitions measured by variables measuring managerial motives and governance, market power, concentration, financial market conditions.

Studies on determinants for Indian acquisitions: Pradhan, and Abraham, (2004) analyzed cross border acquisitions by Indian firms from 2000 to 2003 using four variables export orientation, size, profit, R&D intensity. Kumar N (2007) researched a panel data set of 4271 Indian firms in manufacturing industry for the period 1989 to 2001. The variables determining the probability of acquisitions used were age of the firm, total sales, total R&D expenditure as a percentage of total sales. Royalties and professional fees remitted abroad, import of capital goods, advertising expenses, PBT to Net Worth, exports as a percentage of sales, Dummy for majority foreign owned form (25% or more), dummy for liberalization and sector dummy. The results indicated that firm age, cost effectiveness, export orientation and liberalization have a positive impact. This study researched outward FDI from India, not specific to Acquisitions.

Greenfield Investment [Organic route] vis-à-vis Mergers and Acquisitions [Inorganic route]:

There are two types of Foreign Direct Investment: Greenfield Investment and Mergers and Acquisitions. Greenfield investment abroad is an organic way of internationalization of a domestic firm. Cross border Mergers and Acquisitions are regarded as inorganic way of expansion and internationalization/globalization. Green field F.D.I. relates to investment projects that entail the establishment of new entities and setting up of offices, buildings, plants and factories from scratch. The direct investment enterprise established abroad through Greenfield investment can be a branch, an unincorporated enterprise or an incorporated enterprise i.e. a separate unit maintaining in own accounting books. Greenfield F.D.I. involves capital movement that affects the accounting books of both the direct investor and the direct investment enterprise. Under this form of F.D.I., a direct investor provides resources to a direct investment enterprise in exchange for a claim on the entity. Green field investment involves capital used for the purpose of fixed assets, materials, goods and services and to hire workers in the host countries. This form of F.D.I. contributes directly to capital formation and helps generate employment in the host countries. It adds to the productive capacity of the host country through investment expenditure by the direct investment enterprise. The second mode of entry of F.D.I. is though inorganic route i.e. Mergers and Acquisitions. This entails taking over or merging of capital, assets and liabilities, of the existing enterprises. Cross border mergers and acquisitions have been a major driver of F.D.I. flows for the past few years, not only among and in developed countries but also in some developing countries.

Establishing green field ventures is a core competence of several Indian companies. Tata Group has set up several green field operations in South Africa, Kenya, Nigeria, Sri Lanka, Vietnam, etc. Mahindra and Mahindra has set up new operations in China to make tractors. Indian companies have been very prudent while expanding into new territories. A classic example of prudent expansion is Asian Paints – the second largest manufacturer of decorative paints. Asian Paint started global expansion in 1999. Initially it was done via small acquisition in Egypt, Sri Lanka etc. It was followed by a well managed integration and then a green field expansion. By 2003 the company had enough expertise and experience to play bigger role in acquisition. It acquired Berger International. This acquisition gave Asian Paints a global reach to market its products in over 70 countries.

Until about mid-1990s, green field investment was the norm for overseas operations of Indian firms. There were no recorded cases of overseas acquisitions before mid-1990s. All foreign affiliates formed during this period were joint ventures, usually with minority ownership. It was only after 2003, Indian outward F.D.I. has primarily made in the form of acquisitions. The table 1 brings out recent spurt in India's overseas acquisitions:

Table No. 1 India's overseas acquisitions after 2003

Year	No of acquisitions	Value in Billion dollars
2003	60	1
2004	53	1.6
2005	136	4.5
2006	187	21.9
2007	247	21.5
2008	278	18.3
2009	146	1.5

Source: Dealogic Quoted by Business India August, 2010 issue, Indian Management, February, 2011, Volume 50.

It may be observed from the above table that the tempo had slowed down after worldwide recession in 2008. However, the first decade of the 21st century, particularly since 2003, there is a remarkable increase in cross-border Mergers and Acquisitions by Indian companies. The following table brings out billion dollar acquisitions by Indian companies during the current decade i.e. the first decade of the 21st century:

Table No 2: Billion Dollar Acquisitions by Indian Companies

COMPANY	TARGET	COUNTRY	Value $ Billion	YEAR
Tata Seel	Corus	U.K.	12.2	2007
Bharati Airtel	Zain	Africa	10.7	2010
Hindalco	Novelis	U.S.	6.2	2007
Consortium of ONGC,	Carabobo Acreage	Venezuela	4.9	2010
ONGC Videsh	Imperial Energy	U.K.	2.8	2008
Adani	Linc Energy's Galilee			
	coal basin		2.7	2010
Tata Motors	Jaguar Land Rover	U.K.	2.3	2008
Suzlon	Repower	Germany	1.7	2007
Essar Steel	Algoma Steel	Canada	1.6	2007
Reliance Industries	Pioneer [45%]	U.S.	1.3	2010
Vedanta Resources	Anglo American Zinc	U.K.	1.3	2010
United Spirits	Whyte & Mackay	U.K.	1.1	2007

Indian industry has grown wings. Globalization has given a new meaning and dimension to corporate India. Many Indian firms have, slowly but surely embarked upon global path, leading to emergence of Indian Multinational companies. Indian industry has crossed domestic frontiers and established a credible presence in markets abroad in a very short period of time.

When the Indian economy was liberalized in the early 1990s, with the licensing system for setting up production facilities getting dismantled and foreign investment being encouraged, it was greatly feared that Indian companies would not be able to match up the marketing and financial powers of foreign MNCs. More than a decade later, corporate India has shown that it not only has capabilities to face the might of foreign MNCs who have entered India, but also challenge their position in the international markets.

Foreign acquisitions by Indian firms are still a relatively recent phenomenon. It was only after year 2000 Indian companies have been doing deals outside their borders in any significant manner. Since 1947 Indian companies played the role of joint venture partners of foreign MNCs. The Foreign Exchange Regulation Act, 1973 restricted foreign companies from holding more than 40% of the shares of their Indian subsidiaries. Foreign companies could operate in India only through collaboration with Indian partner. In other words, foreign companies were forced to have an Indian partner for market access in India. However, since liberalization initiated in 1991, foreign companies can have 100% owned subsidiaries in a number of sectors and have dumped their Indian partners.

Table No. 3: Major acquisitions by Indian companies: 2000-2010

Indian company	Target firm	Country	Value [Million $]	Year
Metal and Metal products				
Tata Steel	Corus Steel	U.K.	12,000	2007
Tata Steel	Millennium Steel	Thailand	175	2005
Tata Steel	Nat Steel Asia	Singapore	384	2004
Hindalco [Aditya Birla]	Novelis	U.S.	6000	2007
Essar Steel	Algoma Steel	U.S.	2600	
Ispat Industry	Finmetal Holding	Bulgeria	300	2005
Vedanta Resources	Konkole Copper Mines	Zambia		
Pharmaceuticals				
Dr Reddy's	Betapharm GmbH	Germany	570	2006
Dr Reddy's	Trigenesis	U.S.		
Ranbaxy Lab	Terapia S.A.	Romania	324	2006
Matrix Lab.	Docpharma NV	Belgium	235	2005
Ranbaxy Lab.	R.P.G. Aventis	France		
Genmark Lab.	Lab Klinger	Brazil		
Chemicals				
Tata Chemicals	Indo Maroc Phosphore SA	Morocco	38	2006
Tata Chemicals	Brunner Mond	U.K.	177	2005
Tata Chemicals	General Chemical Ind.	U.S.	1000	
Reliance Industries	Treura GmbH	Germany	95	2004
Automobiles				
Tata Motors	Daewoo Com. Vehicles	Korea	102	2004
Tata Motors	Jaguar Ford/Land Rover	U.K.	2500	2008
Tata Motors	Hispano Carrocera	Spain	16	2005
Bharat Forge	Federal Forge	U.S.		2005
Bharat Forge	Carle Dan Peddinghaus	Germany	49	2003
Mahindra & Mahindra	Jiangling Tractors	China	8	2004
Mahindra & Mahindra	S.Sangyong			
Consumer Goods				

Kraft Foods	United Biscuits	U.K.	522	2006
Tata Tea	Tetley Group	U.K.	431	2000
Tata Tea	Good Earth	U.S.	50	2005
Tata Tea and Tata Sons	Glaceau	U.S.	677	2006
Tata Coffee	Eight O' Clock Coffee	U.S.	220	2006
United Spirits	White and Mackay	U.K.	1110	2007
Power Generation and Electrical Engineering				
Suzlon Energy	Hansen Transmission	Belgium	565	2006
Suzlon Energy	Repower system	Germany	1700	2006
Videocon International	Thomas S.A.	Europe/China		
Tata Power	Kaltim Prima PT Arutmin	Indonesia	1100	
Opto Circuits India	Eurocor GmbH	Germany	600	2005
Information and Communication Technology				
Tata Communication	Tyco Global Network		135	2004
Tata Communication	Teleglobe International	Canada	239	2005
Wipro Limited	Infocrossing	U.S.	600	2007
I-flex Solutions	Mantas Inc	U.S.	113	2006
Sasken Commu. Techology	Botnia Hightrch	Finland	210	2006
T.C.S.	TKS Technosoft	Switzerland	80	2006
Seagate Technology	Evault Inc	U.S.	185	2001
Citeix Software	Sequoia Software	U.S.	185	2006
V.S.N.L.	Teleglobe International	U.S.	254	2005
Patni Computers	Cymbal Corp	U.S.		
ICICI One Source	A.S.G.	U.S.		
Reliance Infocomm	Flag Telecom	U.S.	191	2003
Bharati Airtel	Zain MTN	S. Africa	13000	2009
Petroleun				
O.N.G.C. Videsh	Prtobras	Brazil	1400	2006
O.N.G.C. Videsh	Great Nile Oil Product	Sudan	766	2002
O.N.G.C. Videsh	Sakhalin-I Project	Russia	323	2000
O.N.G.C. Videsh	Great Plutonio Project	Angola	600	2004
Others				
Ballapur Industries	Sabha Forest Ind.Pulp/Paper	Malaysia	209	2006
Tata Power	PT Bumi Resources Coal Mines	Thailand	1100	2007
Sundaran Fasteners	Dana Spicer	U.K.		

Source: Kumar 2008, FICCI 2006, EPW, Research Foundation reports on Current statistics and monthly reviews.

Emergence of Small and Medium Enterprises (SMEs) as the new breed of Indian MNCs:

A new wave of small and medium size Indian Multinationals is creating ripples on the global M. & A. stage. Indian SMEs are on an acquisition spree abroad, buying up firms and expanding their business horizons. An increasing number of Indian Small and medium enterprises are making bids to gobble up overseas firms. Although the lime light is hogged up by big ticket acquisitions, small and medium enterprises in India are increasingly riding the M. & A. wave abroad. Since January, 2010 there have been around 35 overseas deals struck by Indian companies as against over 40 such deals in the entire 2009. Not only the big boys but also the Small Medium size enterprises are leading the set in cherry picking companies in the U.S. and European Union – and not just in Information Technology, I.T.E.S. and Pharma but also in textiles, chemicals, health care, gems and jewellery, irrigation technologies and automobiles. A little known Dishman pharmaceuticals and ventured to acquire

Solution Inc of U.S. for a whopping sum of Rs. 300 crore. Jain Irrigation Systems Limited is also acquiring three U.S. companies spread across agro-products irrigation and manufacturing.

The global landscape is dotted with many small sized deals like Banco Products acquisition of Nederlandse Radiateuren Fabriek of Netherlands [$ 24 million], Inox India's majority stake buy in Cryogenic Vessel Alternatives [CVA] of U.S. [$ 140 million], Compton Greaves' acquisition of Power Technology Solutions in the U.K. [$ 45 million], Hindustan Construction company's acquisition of 66% stake in Karl Steiner AG [$33 million], among a host of others. There are some SMEs which belong to larger groups and by virtue of that have a global presence. Some of the lesser known or smaller Tata companies too have hit the M. & A. trail. For instance, TRF in April, 2010 acquired U.K.'s Hewitt Robins International. A few years ago, Tata Interactive systems, a pioneer in e-learning, acquired Tertia Edusoft's Germany and Switzerland business. In the pharma space, Avantha Group acquired Pyramid Healthcare Solutions [$20 million] in the U.S. and Aegis acquired Sallie Mae [customer service centre] in Texas.

An acquisition abroad is an easy way for small and mid-sized Indian companies to establish a foothold abroad. In some cases, an acquisition ensures an offshore presence along with a competitive supply chain. Some companies like Godrej have gained leadership position in the hair colour space in 19 countries across the globe through the inorganic growth route i.e through mergers and acquisitions. With deflated valuations of potential target companies, the global recession has thrown up enough opportunities for Indian companies to make outbound deals. With the American economy gradually limping back to normal, several business set up some time ago are up for sale. This has helped Indian SMEs, which have benefited from India's liberalization in the last two decades, to acquire these businesses. The appreciation of the Indian Rupee against the U.S. dollar, along with the availability of foreign currency denominated loans has assisted these companies by making foreign acquisitions cheaper for them.

CHALLENGES AHEAD:

Although everything seems hunky dory at the pace at which Indian companies are striking cross-border M. & A. deals, the road may be riddled with challenges in matters relating to cultural differences, corporate governance, competition law, legal risk, etc. Indian companies are not yet accustomed to operating in an environment where there is a strong competition regulator. In the West judiciary is much more efficient, transparent and just. There are no short-cuts available. Consumers are also very conscious of their rights. Certain legislations and regulations, especially pertaining to environment issues, are much stricter in the Western countries. Indian MNCs have to learn to operate in such business environment where the laws, judiciary and consumers behave in a manner far different than that in India.

The management of a global firm is basically different from management of a local firm. The manager of a local firm thinks locally and also acts locally. The manager of a global firm has to '***think globally and act locally***' Think global and act local is the mantra of the success of a global enterprise. One of the fundamental competencies needed in global management is 'a global view.' However, finding managers with that global mind-set is a challenge facing Indian companies going global.

To build a global enterprise, the managers have to become team oriented, process oriented and learning oriented. Indians, though admired for being hard working, suffer from being individualistic, hierarchical and arrogant in their attitude. It is not in their D.N.A. but the result of their upbringing in Indian business environment. Every firm and individual manager is a product of its own business culture. Indians have never been a humble lot, it requires humility to learn from foreign partners and executives, who know more about local markets and the culture of the host country.

A global manager should be culturally literate, especially with reference to the culture of the host country in which he is operating. Multinational companies are becoming transnational in the sense that they are going beyond the nationality of their home country. Very few companies are born global. India is fast losing its low-cost position. Indian firms going abroad should not be content and will not be able to, remain forever in the low cost position. Multinational companies in the developed countries are constantly moving up the value chain with innovation and branding. If the Indian multinational companies want to see them in the list of top 500 largest global companies, they have to adopt global mind-set and adapt themselves to the local environment of the host countries. Indian multinational is an idea whose time has definitely come.

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