Overseas Investments by Indian companies - Evolution of Policy and Trends[*]

Ladies and gentlemen, it is a pleasure to be invited to deliver the key note address at this international conference which is really topical and contextual for the present times and I thank the Bombay Chambers of Commerce for giving me this opportunity. I particularly appreciate the organizers for keeping the focus on host country perspective in regard to overseas expansion by Indian companies and the participants will have the benefit of listening and interacting with experts on the subject.

Globalization and non-discriminatory multilateral trade have opened new doors for Indian corporates. Earlier, there was an accent on inward flows - FDI, portfolio investments, joint ventures and collaborations to tap the growing Indian market, and also technology transfers for enhancing competitiveness of Indian firms. Exports were predominantly the main door to step out towards globalization. Now, the scenario has changed. There is a growing realization that the future growth of Indian companies will be influenced by the share that they can garner in the world market, not only by producing in the country and exporting, but also by acquiring overseas assets, including intangibles like brands and goodwill, to establish overseas presence and to upgrade their competitive strength in the overseas markets.

The policy regime in respect of outward capital flows has accordingly evolved in spirit with the above trend. In line with our calibrated approach to capital account, greater freedom is now available to corporates to make remittances overseas for their overseas expansion. This is reflected in the increasing global operations of Indian corporates in search of global synergies and domain knowledge. Phased liberalization in the policy of overseas investments has enabled Indian corporates to establish presence in overseas markets on an unprecedented scale redefining the global outreach of Indian entities. Behind this push in overseas acquisitions lies a combination of forces – domestic boom, competitive strength, access to credit, keen desire to achieve global scale and above all self-confidence about Indian business's ability to add managerial value on a global scale. As per data available with RBI, during the financial year 2005-06 the total value of Indian direct investments abroad was USD 2.7 billion, mainly accounted for by the manufacturing sector. I may hasten to add

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that this figure doesn't reflect the actual acquisition value. Many acquisitions are taking place through an overseas SPV set up to raise finances from international market and such transactions are not captured in the overseas investment statistics.

Evolution of Overseas Investment Policy

It would be interesting to trace the evolution of public policy in respect of liberalizing outward investments, within the broader ambit of capital account management. Indian overseas investment policies has been progressively liberalized and simplified to meet the changing needs of a growing economy. The policy, which was evolved as one of the strategies for export promotion and for strengthening economic linkages with other countries, has expanded significantly in scope and size, especially after the introduction of FEMA in June 2000.

The evolution has taken place in a sustained manner and could be classified into two distinct phases: the pre 2003 phase and the post 2003 phase. The first phase was export oriented and with restrictions of cash flows from the country reflecting the need to manage capital outflows to conserve foreign exchange resources. An important development during this phase was the transfer of work relating to overseas investment from Ministry of Commerce to RBI in 1995 to provide a single window.

The Pre 2003 Policy Regime

- In December 1969, the Govt. of India for the first time issued formal guidelines for overseas direct investment. Indian parties were permitted minority participation in turnkey projects involving no cash remittances.
- In April 1978, an Inter - Ministerial Committee in the Ministry of Commerce was set up to clear proposals for Overseas Investments. There was a requirement for repatriation of dividend of 50% of the declared profits.
- In 1992 an Automatic Route for overseas investments was introduced, and cash remittances were allowed for the first time. The total value was restricted to $2 million with a cash component not exceeding $0.5 million in a block of 3 years.
- In 1995 the work relating to overseas investment was transferred from Ministry of Commerce to RBI in 1995 to provide a single window, while laying down a policy framework. In terms of the policy, a fast track route was introduced where limits were raised from $ 2 million to $ 4 million and linked to average export earnings of the preceding three years. Cash remittance continued to be restricted to $0.5 million. Beyond USD 4 million, approvals are considered under Normal Route at the Special Committee level. Investment proposals in excess of US $ 15.00 million were considered by MoF with the recommendations of the Special Committee and generally approved if the required resources were raised through the GDR route.
- In March 1997, Exchange Earners other than exporters were also brought under the Fast track Route Indian promoters were allowed to set up second and subsequent generation companies, provided the first generation company was set up under the Fast Track Route. A series of measures to encourage the software industry in India to expand capacity, reduce costs, improve quality and also invest abroad were put in place.
- In 2000, the introduction of FEMA changed the entire perspective on foreign exchange. The revised policies reflected this. The limit for investment up to US$ 50 million, which was earlier available in a block of three years, made available annually without any profitability condition. Companies were allowed to invest 100 per cent of the proceeds of their ADR/GDR issues for acquisitions of foreign companies and direct investments in JVs and WOSs.
- In March 2002, Automatic route was further liberalised wherein Indian parties investing in JVs / WOSs outside India were permitted to invest an amount not exceeding USD 100 million as against the earlier limit of USD 50 million in a financial year. Also the investments under the

automatic route could be funded by withdrawal of foreign exchange from an AD not exceeding 50% of the net worth of the Indian party.

Post 2003 Regime

In March 2003, Automatic Route was significantly liberalized to enable Indian parties to fund to the extent of 100% of their net worth, which was later increased to 200%. As per a recent FICCI study, While India Inc's international acquisitions were rising gradually till 2004, the liberalization in the policy regime for outward investment in 2005, which allowed Indian firms to invest in entities abroad up to 200% of their net worth in a year, triggered a sharp rise in cross-border acquisitions with the number of acquisitions rising from 46 in 2004 to a whopping 130 in 2005.

Present framework

- Proposals for investment overseas by Indian companies/registered partnership firms upto 200 per cent of their net worth as per the last audited balance sheet, in any bonafide business activity are permitted by ADs irrespective of the export/exchange earnings of the entity concerned within this limit loans and guarantees by the parent company and associates are also permitted. The condition regarding dividend balancing has been dispensed with.
- No prior approval of RBI is required for opening offices abroad. For initial expenses, AD banks have been permitted to allow remittance upto 15 per cent of the average annual sales/income or turnover during last two financial years or up to 25 per cent of the net worth, whichever is higher. For recurring expenses, remittance upto 10 per cent of the average annual sales/income or turnover during last two financial years is allowed. Within these limits, ADs can allow remittance by a company even to acquire immovable property outside India for its business and for residential purpose of its staff.
- Partnership firms registered under the Indian Partnership Act, 1932 and having a good track record are permitted to make direct investments outside India in any bonafide activity 200 per cent of their net worth under the automatic route.

I must mention that that the liberalization in the policy on overseas investments has been very much informed by the detailed framework set out by the Government in 1995 when the work was transferred to Reserve Bank of India. For the first time the framework articulated a cohesive policy in regard to overseas investment policy, flexible enough to respond to likely future trends. To quote from the guidelines, they reflected the "need for transparency, recognition of global developments, capturing of Indian realities and learning of lessons from the past". The basic objectives of the policy, as laid out in the notification, were as follows:

- recognising the link between trade and investment flows, to provide a framework for Indian industry and business to access global networks.
- to ensure that such flows, though determined by commercial interests, are consistent with the macroeconomic and balance of payment compulsions of the country, particularly in terms of the magnitude of the capital flows; and
- to give liberal access to Indian business for technology-sourcing or resource-seeking or market-seeking as strategic responses to the emerging global opportunities for trade in goods or services.
- to give a signal that there is a qualitative change in the approach of the Government, from one of regulator or controller to one of facilitator.
- to encourage the Indian industry to adopt a spirit of self-regulation and collective effort for improving the image of Indian industry abroad.

Experience and trends

The overseas acquisitions, which started of on a small scale, have reached to globally visible levels with big ticket acquisitions being announced by large corporates regularly. A report of the Boston Consulting Group (BCG) on the emerging multinationals in the world puts 21 Indian companies among the top 100 such multinationals. Only China with 44 companies is ahead of India. Tata group, Bharat Forge, Infosys, Wipro, ONGC, Ranbaxy and such Indian companies are venturing overseas and expanding at breakneck speed. Industrial goods, steel, automotive components, resource extraction, beverages, cosmetics, pharmaceuticals, mobile communications, software and financial services are some of the sectors where considerable interest has been shown by Indian corporates. The BCG research has shown that 88% of the emerging market global players are driven by the need to gain access to new markets and profit pools. Overseas markets are expected to bring higher margins, revenue and volumes, besides opportunities for further growth. Energy security is another driving force behind global acquisitions.

❖ Liberalised guidelines for overseas investment coupled with lower interest rate hitherto facilitated Indian corporates to invest overseas

- The capex undertaken by Indian industry coupled with buoyancy in economy has strengthened the balance sheet of corporates enabling them to look for inorganic growth by way of acquisitions outside India.
- The confidence shown by the global business community, particularly, availability of foreign funds at competitive rates and acceptance of managerial skills of Indian workforce has led to surge in LBO activities.
- Another trend which is prominent in India's overseas investment is market access. By undertaking overseas acquisition transactions, Indian corporates are gaining entry into regulated market of developed countries. The best example is pharmaceutical industry, where Indian corporates equipped with USFDA approved facilities are looking for acquisition in the regulated market for ease of registration processes. The manufacturing activities will still be in India entailing low cost advantage.
- Transfer of technology is another issue driving for overseas investments. The manufacture of certain products requires technology that is not available to the Indian companies. By acquiring companies abroad, they also acquire advanced manufacturing technologies that further help reduction in the cost of production.
- Indian companies are also going abroad to obtain a new product mix or to acquire products that will otherwise require huge investments and a long time to manufacture indigenously.
- Deployment of excess production resources or better yield on assets is another driving force. The Indian corporates engaged in oil exploration / drilling / rig manufacturing are getting good returns on their assets by deploying their assets in the companies acquired in the high yield market.
- Development of natural resources like mining, oil exploration etc. has given an opportunity to Indian corporates, rich with cash and need for energy, to expand their wings in unchartered territory.
- Post quota regime has also given an impetus to Indian corporates to look for overseas ventures for enhancing their R&D and logistics to cater to developed markets. Indian textile industry with scalable capacities to cater developed markets is feeling handicapped because of logistics issue and delivery frame. However, with bases in and around the European and US market, textile industry is capable of meeting its commitments as well as going for high end designing studios to meet fashion requirements.

- ❖ The IT industry, showcase of emergence of Indian economy, has its presence across the globe by way of subsidiaries to cater to business in a particular region. The acquisitions made by IT companies are primarily for backward or forward value addition in their product profile.

Funding

- Overseas acquisitions are funded through a variety of sources such as drawal foreign exchange in India, capitalization of exports, balances held in EEFC accounts, share swaps, ECBs/FCCBs, ADRs/GDRs, etc.
- A substantial portion of investments takes place through special purpose vehicles (SPVs) set up for the purpose abroad. Existing WOS / JVs or the SPVs are being used to fund acquisitions through LBO route and such transactions are not currently captured in overseas investment statistics. The major investment destinations appear to be the US and European markets. Tax havens like Mauritius and Cayman Islands also feature significantly in the Indian acquisitions or setting up of new WOS/JVs.
- In recent times, sustained growth in corporate earnings has boosted the profitability and strengthened the balance sheets of Indian companies. This has, in turn, strengthened their credit ratings and ability to raise funds overseas.
- Unlike most international M&A transactions that typically feature stock swaps in the financing arithmetic, Indian acquirers have for the most part paid cash for their targets, helped by a combination of internal resources and borrowings. Share swaps have not yet emerged as a favored payment option in India, except in a couple of large transactions in the software industry.

Finance by Indian banks: As per existing instructions banks are not allowed to finance the promoters' contribution towards the equity capital of a company as it should come from their own resources. However, in view of the expertise in certain areas developed by Indian corporates over the years and the importance attached to leveraging of such expertise for enhancing the international presence of Indian corporates, w.e.f June 7, 2005, banks have been allowed to extend financial assistance to Indian companies for acquisition of equity in overseas joint ventures/wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment, in terms of a Board approved policy, duly incorporated in the loan policy of the bank. Such policy should include overall limit on such financing, terms and conditions of eligibility of borrowers, security, margin, etc. While the Board may frame its own guidelines and safeguards for such lending, such acquisition(s) should be beneficial to the company and the country. The finance would be subject to compliance with the statutory requirements under Section 19(2) of the Banking Regulation Act, 1949.

In April 2003 banks were permitted to extend credit/non-credit facilities to Indian Joint Ventures (JVs) (where the holding by the Indian company is more than 51%) / Wholly Owned Subsidiaries (WOS) abroad up to the extent of 10 per cent of their unimpaired capital funds (Tier I and Tier II capital), subject to certain terms and conditions. On November 6, 2006, in order to facilitate the expansion of Indian corporates' business abroad, it was decided to enhance the prudential limit on credit and non-credit facilities extended by banks to Indian Joint Ventures (where the holding by the Indian company is more than 51%) /Wholly Owned Subsidiaries abroad from the existing limit of 10 per cent to 20 per cent of their unimpaired capital funds (Tier I and Tier II capital).

Role of EXIM Bank

Exim Bank has been involved in supporting Indian direct investment overseas since its inception and its role has been unique in this regard, given its mandate. IDBI had first initiated a program of rupee term loans to Indian companies towards their equity contribution in overseas ventures. The related facilities extended by IDBI were taken over by Exim Bank on March 1, 1982 as part of the transfer of export financing functions of IDBI to Exim Bank under the Export-Import Bank of India Act, 1981. Subsequently, Exim Bank developed the program further and enlarged its scope from time to time with the objective of facilitating Indian corporates' access to new markets and technologies, and thereby enhancing their export capabilities and international competitiveness. The Overseas Investment Finance (OIF) program of Exim Bank seeks to cover the entire cycle of Indian investment overseas including the financing requirements of Indian Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) with a suite of financing instruments, which include:

a. Loan against investment in share capital

b. Loan against Indian promoter company's loan

c. Loans to Overseas Indian Ventures

d. Mezzanine Finance:

e. Non-fund based facilities to Indian Overseas Ventures:

f. Direct Equity Investment:

Banking Presence Overseas

It is not very surprising that in the very period when Indian companies have increased overseas presence significantly, in parallel the operations of Indian banks overseas has also increased. There are generally four forms of banking presence abroad, viz.

(i) Representative Office,

(ii) Branch [including specialized branch like Off-shore Banking Units (OBUs)]

(iii) Subsidiary and

(iv) Joint Ventures.

The choice of any particular form of presence is guided mostly by the objective of the bank seeking presence in a particular country/location, the laws and regulations of the host country and the cost and return from the proposed venture, which in turn is a factor of regulatory prescriptions and business potential.

As on December 31, 2006, nine public sector banks and three private sector banks have 113 overseas branches spread over 27 countries. Out of these, three banks viz. BOB (40), SBI (30),and BOI (21) have got 80.5 % of the overseas branches. As regards geographical spread, Indian banks have branch presence of 22 in UK, 9 each in Singapore, Mauritius, Fiji, 8 in Hong Kong, 7 in Sri Lanka and 6 in USA.

In terms of total asset size, the operations of Indian banks overseas have increased by a significant 113.5% over the last five years i.e. 2002-06. As on March 31, 2006, total assets of all Indian bank branches overseas stood at USD 29.34 billion.

Overview

To conclude, there is great dynamism amongst Indian corporates to globalize and in the years to come we are going to have more Indian multinationals. These will include not only the large corporates but also medium size corporates. Companies have to determine the most optimal method for funding these acquisitions as this has implications for the domestic balance sheets of the Indian companies and external debt profile depending on the source of funding. In case of investments financed through debt in the books of domestic entity and/or against guarantees issued by the Indian entity, it could involve a full or partial recourse to the Indian entity. In case there is recourse to the company, it is a direct external liability of the company to that extent.

Indian companies appear to have so far balanced all these considerations and raised bulk of these funds through LBO for large acquisitions which reduces the risk on the domestic balance sheet.

As regards external debt, the policy on ECBs allows ECBs for overseas acquisitions within the overall limit of USD 500 million per year under the automatic route. The overall remittances from India and non-funded exposures should, however, not exceed 200 percent of the net worth. In general, this policy has served us well so far.

Another issue relates to capturing the data in respect of overseas remittances taking into account the innovative funding structures being adopted in many cases. Accuracy and timeliness in reporting has to be ensured to enable meaningful monitoring at our end. The requirements of compilation of BoP statistics have to be kept in mind, in view of the significance of contribution of overseas investments. We are working on revising the existing reporting formats, in consultation with some of the leading corporates, to first, rationalize and simplify these and second, to make them e-enabled.

Thank you all and wishing the conference a great success.