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Outward Foreign Direct Investment from India

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Discussion Draft

Part of the EMF Series of papers on International Capital Flows, Domestic Capital Markets and Growth and Development in Emerging Markets Countries

2006 Global Meeting

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Abstract

The paper examines the key features of outward FDI from India. It summarizes the key phases in the evolution of outward FDI from India and the key drivers of overseas investment by Indian companies. Given the strong fundamentals driving this overseas expansion, the growth momentum of outward FDI from India is likely to continue.

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The author acknowledges the assistance rendered by Rakesh Mookim and Karthik Hari of ICICI Bank in the preparation of this paper.

Introduction

The world today is characterised by an increasing integration of economies and markets, with every nation seeking to benefit from the process of globalisation. This is true even at the micro level where individual firms are rapidly expanding beyond domestic markets, in an effort to participate in profitable growth opportunities in international markets. Globalisation has led to the liberalisation of trade and investment regimes. There has been an increase in competition from foreign firms through imports, inward FDI, non-equity forms of participation and various other means. Companies can no longer restrict themselves to the domestic market as a relatively secure source of profits. Competing at the global level requires firms to expand beyond domestic markets in order to achieve maximum efficiency. Increased access to markets and factors of production enables firms to operate efficiently and cater to an enlarged set of clients. Outward foreign direct investment (FDI) can play an important role in enhancing the competitiveness of enterprises by providing access to strategic assets, technology, skills and natural resources. Two distinct sets of factors govern the flow of outward FDI. These are:

1. Macroeconomic and policy environment: This includes factors such as domestic market growth constraints, policy liberalization, trade, investment and taxation treaties, and incentives in the form of tax rebates and investment insurance by home governments.

2. Corporate specific factors: These include push factors such as rising costs in domestic markets, increased competition and corporate internationalization policy and pull factors such as growth and investment opportunities in foreign markets, lower production costs, availability of natural resources and host country policy incentives.

India has emerged as one of the fastest growing economies in the world and is drawing increasing international attention. The vast opportunities presented by Indian markets make India an important investment destination for international companies. Parallely, in recent years, investments by Indian enterprises in overseas markets have been increasing significantly. Overall economic growth, increasing competitiveness, improving quality, increasing corporate profitability, liberalization of regulations and improved availability of finance have resulted in a significant increase in outward FDI from India.

Trends in outward FDI

The evolution of outward FDI flows from India can be divided into two distinct phases differing in terms of size, motivations and ownership patterns. While the first phase was marked by a restrictive policy environment, the second phase saw substantial liberalisation of the policy regime. After the phase of restructuring in the late 1990s and the improved business cycle in recent years, Indian firms have emerged as more profitable and competitive. These factors along with greater access to finance led to a significant increase in outbound mergers and acquisitions during the second phase. The main characteristics of outward FDI in the two phases are summarised in table 1.

Table 1: Phases in the evolution of OFDI in India

Phase I (till 2003)	Phase II (2003 onwards)
1. Increased access to natural resources, markets and technology were the key drivers.	1. Apart from earlier reasons, OFDI driven more by strategic and market concerns.
2. OFDI was largely led by the manufacturing sector.	2. A variety of sectors contribute to OFDI with the services sector emerging as an important contributor. Sectors such as pharmaceuticals and information technology emerging as major players in cross border mergers and acquisitions.
3. Indian companies were largely minority shareholders	3. Indian equity participation is largely in the form of majority ownership
4. Policy framework was restrictive and few sources of finance were available.	4. Policy framework liberalised; increased access to sources of finance along with significant internal revenues supported outbound deals growth.

Prior to fiscal 2000, FDI reported by India constituted only of equity flows. The Reserve Bank of India (RBI) revised the definition of FDI flows from fiscal 2001 to include three categories of capital flows under FDI. These include

1. Equity capital: This includes equity in branches, shares in subsidiaries and other capital contributions.

2. Re-invested earnings: This includes retained earnings of foreign subsidiaries and affiliates.

3. Inter-company debt transactions: This includes inter-corporate debt transactions between associated corporate entities.

According to the United Nations Conference for Trade and Development, India's outward FDI performance ranking improved from 80 in 2000 to 54 in 2004. Outward FDI from India has been increasing significantly since the past few years. It increased from US$ 759 mn in fiscal 2001 to US$ 1,958 mn in fiscal 2006, an annual growth of over 30%.

Table 2: Outward FDI from India

OFDI (US$ mn)	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006*
Equity	344	570	611	1,122	1,261	978
Reinvested Earnings	340	700	1,104	552	700	364
Other Capital	75	121	104	260	388	616
Total	759	1,391	1,819	1,934	2,349	1,958

** Provisional*
Source: Reserve Bank of India

Drivers of outward FDI

Increasing competitiveness, improved corporate governance, profitability and financial strength have been key drivers for the international expansion of Indian enterprises. The debt-equity ratio of non financial companies reduced from 1.3 in fiscal 1999 to 0.8 in fiscal 2005. Cash accruals increased from Rs. 296 bn in fiscal 2000 to Rs. 908 bn in fiscal 2005, an annual growth of over 40%. The quality of products and services by Indian firms has also seen significant improvement. Eleven Indian companies won the Deming prize between 2002 and 2005 as compared to only two between 1998 and 2001 and none prior to that.

Access to technology, distribution networks, skills, markets and brand names have been strategic considerations driving Indian enterprises to expand abroad. In addition, Indian firms are looking to secure natural resources and have invested in resource-rich countries like Australia, Indonesia, Sudan, the Russian Federation and West and Central Asia. The liberalization of the Indian economy and greater openness of markets have also contributed to the expansion of overseas operations. India is a good example of an economy where domestic firms have invested abroad to establish their portfolio of locational assets as a source of increasing competitiveness. The main drivers of outward FDI from India are:

1. High growth sectors such as pharmaceuticals, information technology and auto ancillaries are poised at an inflection point. The pharmaceuticals sector, in particular, has witnessed an unprecedented increase in cross-border deal activity. With growth in domestic markets at more or less stable levels, firms in these sectors are looking to expand overseas operations and emerge as key global players.

2. Strong equity markets, improved profitability and increased access to finance are major factors driving outbound mergers and acquisitions by Indian companies.

3. As a consequence of rapid growth, Indian firms are increasingly benchmarking against global firms. Along with strong managerial expertise and improved efficiency, this has prompted Indian firms to compete at a global level.

4. Building brand names and strengthening the use of Indian brands abroad are a key driver of overseas investments. Examples include Tata Motors acquisition of Daewoo Commercial Vehicle Company (Republic of Korea), Infosys Technologies' acquisition of Expert Information Services (Australia), Ranbaxy Technologies' acquisition of RPG Aventis (France) and Tata Tea's acquisition of Tetley Tea (United Kingdom).

5. Indian firms have placed increasing importance on acquisition of technology, knowledge and markets to improve competitiveness and move up the production value chain. Examples of such deals are; the acquisition of Nerve Wire (United States) by Wipro, I-Flex's acquisition of Supersolutions Corp. (United States) and Wockhardt Ltd's purchase of a pharmaceutical company in the United Kingdom. Reliance Infocomm bought Flag Telecom (United Kingdom) for access to the undersea cable network. Access to technologies has also included the setting up of research and development centres in key locations. For example, Ranbaxy Laboratories has R&D facilities in various countries, including China and the United States.

6. Securing energy supplies have become a priority for Indian companies. Domestic oil companies such as ONGC have increased their efforts to secure supplies of natural resources to meet the growing demand at home. Indian firms have been actively acquiring natural resources abroad. Hindalco's acquisition of copper mines in Australia, ONGC's acquisition of oil fields in Sudan and ONGC-Videsh's acquisition of a 20.0% stake in the Sakhalin-1 oil and gas field in the Russian Federation are prominent examples of such ventures.

7. Indian firms are looking to build a portfolio of locational assets to remain competitive internationally. Access to factors of production in various geographies leads to an intra-firm division of labour, allowing the production of distinct components of a product at places where they can be produced at least cost. This becomes a source of increased efficiency and competitiveness.

Sectors

More than half of India's outward FDI between fiscal 2001 and fiscal 2006 was concentrated in manufacturing, followed by non-financial services (table 3). Reflecting the structural shift in the Indian economy towards the services sector, Indian software and service providers have emerged as important players in the overseas expansion by Indian firms. Indian BPO firms are increasingly looking to expand their client base in overseas markets by catering to firms not very keen on outsourcing business to an offshore location. Investments by IT firms were largely responsible for India emerging as the tenth largest investor in the United Kingdom at the end of 2004. Indian companies such as Tata Consultancy, Infosys Technologies and Wipro have operations in many foreign countries.

Cross-border mergers and acquisitions have increased in recent years, particularly for entry into developed countries. This has been driven by increased corporate profitability and financial reserves for Indian firms. The preference of Indian corporations is also shifting from minority-owned foreign affiliates to majority-owned ones.

Table 3: Industry distribution of approved outward FDI flows

	Manufacturing		Financial Services		Non-financial services		Trading		Others	
US$ mn	Amount	% share	Amount	% share	Amount	% share	Amount	% share	Amount	% share
FY2000	548.8	31.2	4.3	0.2	1,143.5	65.1	58.3	3.3	2.3	0.1
FY2001	370.7	26.8	16.6	1.2	876.5	63.4	89.2	6.5	29.1	2.1
FY2002	2,210.9	73.2	48.6	1.6	565.5	18.7	139.2	4.6	61.3	2.1
FY2003	1,056.7	71.9	1.8	0.1	280.2	19.1	69.9	4.8	61.7	4.2
FY2004	765.6	52.8	35.1	2.4	438.8	30.3	76.9	5.3	134.1	9.2
FY2005	2,026.4	72.3	9.2	0.3	548.2	19.5	69.1	2.5	151.3	5.5
FY2006[1]	864.4	53.8	17.7	1.1	482.6	30.0	130.9	8.1	111.0	6.9
Total[2]	7,843.6	58.1	133.3	1.0	4,335.3	32.1	633.4	4.7	550.9	4.1

1. Till January 2006 2. fiscal 2000 – fiscal 2006
Source: Ministry of Finance

During 2005 and 2006, there has been a significant increase in outbound mergers and acquisitions by Indian firms. In 2005, there were 136 outbound deals as compared to 56 inbound deals. The first six months of 2006 have seen around 76 outbound deals valued at US$ 5.20 bn. In the month of June 2006 alone, ten cross border deals with a combined value of US$ 1.50 bn were finalised. The largest proportion of outbound acquisitions by volume was in Europe, which accounted for over half of the deals, while South America received the highest investment in value terms, largely due to high value oil and gas deals in the region. Some significant deals in 2006 are shown in table 4.

Table 4: Major overseas acquisitions by Indian firms in 2006

Acquirer	Target	Region	Value (US$ mn)
ONGC Videsh Ltd	Brazilian Oil Field	Brazil	1,400
Dr. Reddy's Laboratories	Betapharm Arzneimittel	Germany	572
Suzlon Energy Ltd	Hansen Transmissions International	Belgium	565
Ranbaxy Laboratories Ltd	Therapia S.A	Romania	324
Ballarpur Industries (along with JP Morgan)	Sabah Forest Industries	Malaysia	261
Subex Systems	Azure solutions	UK	140
United Phosphorous (through subsidiary)	Advanta Netherlands Holdings	Netherlands	119

Source: Grant Thornton, PricewaterhouseCoopers

Destinations

The most important destinations for outward FDI are Russia, which accounted for about 15% of total cumulative outflows during fiscal years 2003 to 2006 (till January), followed by Sudan and the United States that accounted for about 14% and 12% of the outflows. Investments in Russia and Sudan were largely in the form of acquisition of natural resources whereas investments in the United States were driven by strategic concerns and access to markets and technology. India is also emerging as an important investor in Europe. During the first four months of 2006, the largest proportion of outbound deals, by value, were made in Europe, which accounted for about 52% of all outbound deals. It was followed by South America, which contributed to about 39% of the outbound deal value. The 20 most preferred destinations during fiscal 2003 and fiscal 2006 (till January) are listed in table 5.

Table 5: Country-wise approved Indian direct investment

US$ mn	FY2003	FY2004	FY2005	FY2006[1]	Total[2]	%share
Russia	0.2	1.4	1,076.2	1.1	1,078.8	14.7%
Sudan	750.0	162.0	51.5	59.6	1,023.1	13.9%
USA	185.3	207.1	251.7	225.4	869.6	11.9%
Mauritius	133.4	175.6	149.4	67.3	525.6	7.2%
Singapore	46.8	15.9	239.0	170.2	471.9	6.4%
Australia	95.0	92.9	158.8	73.9	420.5	5.7%
Bermuda	29.0	142.5	221.3	2.6	395.3	5.4%
U.K	34.5	138.5	71.9	137.3	382.2	5.2%
Netherlands	15.9	30.2	30.7	244.0	320.8	4.4%
UAE	12.6	32.1	41.9	118.3	204.8	2.8%
British Virgin	3.3	4.9	131.4	25.8	165.4	2.3%
Hong Kong	14.8	16.2	73.6	31.4	136.0	1.9%
Kazakhstan	0.1	75.0	44.0	9.6	128.7	1.8%
China	29.6	26.6	15.1	45.0	116.3	1.6%
France	1.8	84.4	22.3	0.6	109.1	1.5%
Indonesia	0.1	19.3	80.8	7.8	108.0	1.5%
Cayman	-	-	2.8	82.3	85.1	1.2%
Sri Lanka	6.6	44.5	10.0	14.1	75.2	1.0%
Malta	24.4	40.3	10.0	-	74.7	1.0%
Belgium	0.3	9.2	1.1	52.1	62.6	0.9%
Others	88.6	132.6	120.7	242.4	584.3	8.0%
Total	1,472.1	1,451.0	2,804.0	1,610.8	7,337.9	100.0%

1. Till January 2006 2. fiscal 2003 – fiscal 2006
Source: Ministry of Finance

Policies and regulatory framework

From a policy perspective, outward FDI received little regulatory support in India till 1990. This was largely due to the view that an emerging economy like India was capital constrained and needed to conserve foreign exchange. The regulatory framework, therefore, favoured the import of capital rather than capital exports. Improvements in the regulatory framework and policies have played a vital role in increasing investments abroad. The changes were driven by the following factors:

- It was recognised that individual companies having the ability to expand abroad were constrained by the regulatory framework.

- Companies needed a portfolio of locational assets to remain competitive. Firms without a portfolio of locational assets are not able to optimally structure their production processes and gain from the efficiencies generated thereby.

This has led to the conclusion of bilateral investment treaties (BITs) and double taxation treaties (DTTs). India has concluded such treaties with more than 65 nations, encouraging firms to invest in these nations. Over the last few years, Indian firms are increasing their investments in software, biotechnology, automotive and oil sectors and outward FDI from India is gaining in importance. Policy with respect to outward FDI has been successively liberalized. Till 1991, joint venture enterprises with only a minority Indian equity were permitted. The main motive for outward FDI was export promotion and prohibited cash remittances towards equity participation, requiring it to be in the form of exports of Indian made capital goods and expertise.

During 1990s, the government instituted an automatic approval system for outward FDI and successively raised the permissible investment limits. It also reduced other regulatory constraints in promoting Indian direct investment abroad. The past six years have witnessed the introduction of significant policy changes. Also, the Reserve Bank of India has been designated as the nodal agency for administering policy. After 2003, the overseas investment policy has been further liberalised with listed Indian companies being permitted to invest up to 25.0% of their net worth in equity of foreign companies (having a shareholding of at least 10.0% in an Indian company listed on a recognised stock exchange in India) listed on a recognised stock exchange. Indian corporates/registered partnership firms are allowed to invest in entities abroad up to 200.0% of their net worth and the existing monetary ceiling of US$ 100.0 mn has been removed. Further the stipulation of a minimum net worth of Rs. 150.0 mn for Indian companies engaged in financial sector activities in India has also been removed. In 2005, banks were permitted to lend money to Indian companies for acquisition of equity in overseas joint ventures, wholly owned subsidiaries or in other overseas companies as strategic investment. In 2006, the automatic route of disinvestment was further liberalised. Indian companies are now permitted to disinvest without prior approval of the RBI in select categories. Further, to encourage large and important exporters, proprietary/unregistered partnership firms have been allowed to set up a JV/WOS outside India with prior approval of RBI.

Box 1
Selected changes to Indian overseas investment policy

- Indian companies permitted to undertake overseas investments by market purchases of foreign exchange without prior approval of RBI up to 100.0% of their net worth; up from the previous limit of 50.0%.

- An Indian company with a satisfactory track-record allowed to invest up to 100.0% of its net worth within the overall limit of US$ 100.0 mn by way of market purchases for investment in a foreign entity engaged in any bona fide business activity from 2004. The provision restricting overseas investments in the same activity as its core activity at home of the Indian company was removed. Listed Indian companies, residents and mutual funds permitted to invest abroad in companies listed on a recognised stock exchange and in company that has the shareholding of at least 10% in an Indian company listed on a recognised stock exchange in India.

- Indian companies in Special Economic Zones permitted to undertake overseas investment up to any amount without the restriction of the US$ 100.0 mn ceiling under the automatic route, provided the funding was done out of the Exchange Earners Foreign Currency Account balances.

- The three years profitability condition requirement was removed for Indian companies making overseas investments under the automatic route.

- Overseas investments were allowed to be funded up to 100.0% by ADR/GDR proceeds up from the previous ceiling of 50.0%. Further an Indian firm that had exhausted the limit of US$ 100.0 mn in a year could apply to the RBI for a block allocation of foreign exchange subject to such terms and conditions as may be necessary.

- Overseas investments were opened up to registered partnership firms and companies that provided professional services. The minimum net worth requirement of Rs. 150 mn for Indian companies engaged in financial sector activities in India was removed for investment abroad in the financial sector.

- In 2004, Indian firms were allowed to undertake agricultural activities, which was previously restricted, either directly or through an overseas branch; and are now permitted under the automatic route.

- In 2004, the RBI further relaxed the monetary ceiling on Indian companies' investment abroad. Indian companies can now invest up to 100.0% of their net worth without any separate ceiling even if the investment exceeds the US$ 100.0 mn limit. Furthermore, Indian companies can now invest or make acquisitions abroad even in areas unrelated to their business at home.

- In 2005, banks were permitted to lend money to Indian companies for acquisition of equity in overseas joint ventures, wholly owned subsidiaries or in other overseas companies as strategic investment.

- In 2006, the automatic route of disinvestment was further liberalised. Indian companies are now permitted to disinvest without prior approval of the RBI in select categories. To encourage large and important exporters, proprietary/unregistered partnership firms have been allowed to set up a JV/WOS outside India with the prior approval of RBI.

Financing

Indian companies are scaling up the size of their overseas acquisitions. Many Indian firms have bought out companies abroad that are larger in size compared to them. A few examples include engineering major Punj Lloyd's acquisition of Singapore-based engineering firm SembCorp for US$ 640 mn and oil drilling major Aban Loyd, which had a turnover of US$ 110 mn in 2005-06, acquiring a 34% stake in Sinvest ASA, a Norwegian drilling company for US$ 446 mn. Subex Systems Ltd recently acquired UK-based Azure Solutions Ltd, the world's largest revenue-assurance company, in a stock-plus-cash deal exceeding US$ 140 mn.

The funding of M&A deals is increasingly being done through external funding as opposed to internal accruals giving rise to the ability to fund larger deals. Stock plus cash deals and increasing institutional funding are the key sources of funds for large mergers and acquisitions. Indian companies have also engaged in leveraged buyouts and completed acquisitions by raising debt against the cash flows of the acquiree. Additionally, Indian companies have also accessed global financial markets for raising adequate funds. The issue of ADRs/GDRs and use of instruments like External Commercial Borrowings (ECBs) and FCCBs have increased significantly in the past few years. External commercial borrowings rose from US$ 5 bn in fiscal 2005 to US$ 7 bn in fiscal 2006. In the first two months of fiscal 2007, external commercial borrowings stood at US$ 1 bn. Issue of ADR/GDRs increased by almost 417% in 2006 to US$ 2.5 bn compared to US$ 613 mn the previous year. In recognition of the funding requirements of Indian firms engaged in large outbound deals, improvements in the policy framework have also been made. Since May 2005, Indian banks have been permitted to finance overseas acquisitions by domestic companies. This has encouraged mergers and acquisitions undertaken by Indian companies as Indian banks are more experienced with the domestic credit situation and have a better understanding of the local business environment.

Conclusion

Outward FDI from India has been growing at an impressive rate. Increasing competition, improved corporate profitability and governance together with the need for greater access to technology, markets and natural resources have led Indian enterprises to expand their overseas operations. Greater liberalisation, improvement in the policy framework and increased access to various sources of finance have helped Indian firms in this process. As the outlook for the Indian economy remains robust and profitability of firms is expected to grow, Indian companies will be looking to scale up further and acquire meaningful market shares at the global level. India can be expected to emerge as an important investor in the global economy and the growth momentum of outward FDI from India is likely to continue.

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