India

Deal activity slows but opportunities galore

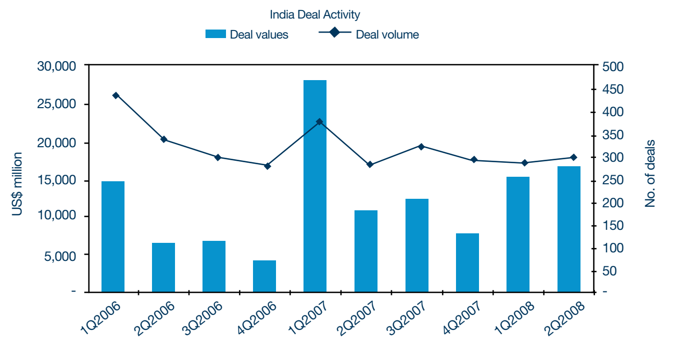
Current Environment

The Indian economy grew by an estimated 9% during the fiscal year ending in March 2008, and while this was lower than the 9.6% growth achieved in 2006-07, this completes three years of 9% or higher GDP growth for India. Significantly, the key contributor to the robust 9% growth during 2007-08 was the large agriculture sector, which registered growth of 4.5% compared to 2.7% last year. While the services sector continued to show a double-digit growth rate, albeit at a lower level than the previous year, it was the manufacturing sector which primarily contributed to the fall in GDP growth; manufacturing grew by just 8.8% in 2007-08 as compared to 12% in the previous fiscal year.

Rising crude oil prices have resulted in higher inflation, now standing at 11%. The government has been attempting to rein in inflation by raising interest rates, and making some changes to its indirect tax structure, with a view to reduce consumer prices. It has also restricted the export of cement and steel, with a view to avoiding domestic shortages. However, putting together all these measures have not been enough to control inflation. The widening current account deficit is another key concern, and with the rising crude oil prices, the rupee is starting to depreciate, compounding matters further. The key challenge, however, is the impact this high cost regime may have on infrastructure development and supply creation, which may in turn impact and impede future growth.

The Indian stock markets have reacted to all the bad news, and the Bombay Stock Exchange Index, after touching a high of 21,700, has plummeted to below 13,000 in June 2008. The good news, however, has been the reasonably stable investment environment, and overall sentiment remains positive, with global investors continuing to have confidence in India. Foreign direct investment ("FDI") went up to US$24.5 billion in 2007-08, a 55% increase over the US$15.7 billion of inward investment in 2006-07. Sectors such as services, information technology ("IT"), telecoms, construction and real estate accounted for over 50% of the total FDI. The Ministry of Commerce and Industry expects FDI flows in 2008-09 to touch US$35 billion. The bullishness of financial institutional investors ("FII") and the rise in FDI inflows have resulted in India's foreign exchange reserves increasing to over US$300 billion in 2007-08.

Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 30 June 2008

The year 2008 began by keeping pace with the heightened deal activity of 2007, with the completion of the much anticipated acquisition of Jaguar and Land Rover by Tata Motors for US$2.3 billion. However, there were no transactions of equivalent value to the Tata – Corus and Hindalco – Novelis deals of 2007. Activity has declined, both in value and volume terms. While the total number of transactions fell from 663 in H1 2007 to 591 in H1 2008, total deal value saw a sharper slump, dipping by over 17% from US$38.4 billion in H1 2007 to US$31.8 billion in H1 2008. Key sectors which contributed to investment activity during this period included pharmaceuticals, IT&ITeS, banking & financial services and real estate.

Indian deal activity by type for H1 2008 was as follows: inbound (42%), outbound (30%) and domestic (28%). We take a closer look at these below:

Outbound activity

A total of 138 deals valued at US$9.5 billion were made over this period. Significant outbound deals, announced during this period included the following:

- Tata Chemicals Limited to acquire General Chemical Industrial Products Inc for US$1 billion
- Siva Ventures Limited to acquire JB Ugland Shipping A/S for US$300 million
- Indiabulls Real Estate Limited to acquire Dev Property Development plc for US$274 million
- Tata Motors to acquire Jaguar and Land Rover from Ford Motor Company for US$2.3 billion
- Jubilant Organosys Limited to acquire Draxis Health Inc for US$255 million
- GMR Infrastructure to purchase a 50% stake in InterGen NV for US$1.1 billion

Financing overseas acquisitions has been tougher this year, owing to the global credit market conditions. As a result, India Inc. has largely relied on the strength of its own balance sheet and cash flows, apart from the Foreign Currency Convertible Bonds ("FCCBs") and Qualified Institutional Placement ("QIP") routes. There have been some near misses, however, which would have added to the tally, including Essar's bid for Esmark, where Essar was outbid by Severstal. Sterlite Industries' proposed acquisition of Asarco LLC has also encountered a challenge in the form of a counter-offer from Grupo Mexico.

Domestic deal activity

Domestic activity remained more or less flat in H1 2008 compared to the same period in the previous year. The first six months of 2008 saw 302 deals with a value of US$9 billion. There have been several deals in the financial services sector, which is undergoing consolidation. These include the merger of Centurion Bank of Punjab with HDFC Bank and Infrastructure Development Finance Corporation's acquisition of the mutual fund business of Standard Chartered in India for a consideration of US$205 million. Some other key domestic deals include:

- AAA Project Ventures Pvt Ltd acquired warrants convertible into a 15.38% stake in Reliance Energy Ltd, an electric utility company, for a total value of US$1.9 billion in a privately negotiated transaction.
- Aditya Birla Group's Idea Cellular has announced acquisition of a 39.2% stake in Spice Communications Ltd. for a consideration of approximately US$637 million.
- Welspun Power & Steel's acquisition of Vikram Ispat, an iron sponge manufacturer, from Grasim Industries (Aditya Birla Group) for approximately US$240 million.

Inbound activity

The downturn in global and domestic economy impacted the inbound deal activity in India in the first half of 2008. The total value of overall inbound deals announced in the first half of 2008 was US$13 billion, a fall of over 45% over H1 2007. However, the decline was lower in volume terms at 15% from 177 deals in H1 2007 to 151 in H1 2008. Key strategic inbound deals during this period were as follows:

- Japanese drug firm Daiichi Sankyo announced acquisition of over 43% stake in India's largest pharmaceutical company, Ranbaxy Laboratories, for a consideration of US$3.4 billion.
- Telekom Malaysia's investment arm TM International has announced a US$1.7 billion acquisition of a 15% stake in Indian wireless communications provider, Idea Cellular.
- Dublin-based CRH plc, the world's second largest maker and distributor of building materials, acquired a 50% stake in an Indian cement manufacturer, My Home Industries Ltd, for a consideration of US$456 million.
- French firm Lafarge SA acquired Indian engineering and construction major Larsen and Toubro's (L&T) ready mix concrete business for approximately US$350 million.

Private Equity

Private equity investments (both inbound and domestic) have been hit by the non-availability of leverage for buyouts. It was expected that India would be different, since most private equity investments in India are for growth capital. However the over 35% fall in the Indian stock markets index has meant that both private equity investors and the promoter community have shied away from committing themselves. While private equity investors are wary of investing even at current levels, expecting a further correction, promoters too are wary of diluting equity at this stage. As a result, private equity activity has slowed down and the impact thereof is likely to be more visible in H2 2008. In numerical terms, private equity accounted for 160 deals during H1 2008 with deal value in excess of US$6 billion. Some of the notable private equity deals during H1 2008 include:

- US-based Providence Equity Partners Inc's investment of US$640 million in Aditya Birla Telecom Ltd, a wireless telecommunication services provider, for a 20% stake.
- DLF Assets, the property fund of DLF Ltd, India's largest real estate developer by market capitalisation, raised US$450 million from Symphony Capital, a London-based investment firm.
- Kohlberg Kravis Roberts & Co.'s ("KKR") investment of US$250 million in Bharti Infratel (the subsidiary and tower arm of telecom firm Bharti Airtel Ltd.) for a 2%–2.5% stake. This is the second deal by KKR in India.
- US-based Farallon Capital Management LLC invested approximately US$246 million in Indiabulls Power Services Ltd. for a 23% stake.
- Government of Singapore Investment Corporation's ("GIC") investment of US$209 million for a 25.4% equity stake in apparel firm Reid & Taylor India (wholly-owned subsidiary of Indian company S Kumars Nationwide).

Private equity funds however, continue to have confidence in the India growth story and a number of them have raised India dedicated funds, including 3i and JP Morgan which raised India Infrastructure funds aggregating US$1.2 billion and US$2 billion respectively. CDC Group, the UK government-backed emerging markets fund of funds investor, will invest US$250 million in three India focused infrastructure and real estate focused funds. CDC will invest US$100 million each in IDFC India Infrastructure Fund and the Actis India Real Estate Fund, while Kotak India Realty Fund will get US$50 million. These three funds are together expected to raise a total of US$1.6 billion for investment in India.

Outlook

There is a definite slowdown in economic activity in the last six months. This is compounded by a degree of political uncertainty in relation to the continuing support of coalition partners to the Congress-led government at the centre. Yet, there is optimism that India will manage to achieve 8%-9% growth this year.

M&A activity is anticipated to be lower than last year, primarily on account of the fall in outbound investments and private equity investments. However, softening of valuations in India has resulted in larger inbound interest this year, and as Indian businesses evaluate the impact of the changing global economic scenario on their businesses, we could witness more transactions like the Ranbaxy–Daiichi deal. A certain amount of domestic consolidation is also expected. After a period of opportunistic investing, private equity activity is expected to pick up by the last quarter of 2008, as valuation expectations settle.

Regulation is not a major driver of deal activity this year. However, some recent regulatory changes which may aid M&A activity in 2008 include the following:

- Indian companies in the energy and natural resources sectors, such as oil, gas, coal and mineral ores, have been permitted to invest overseas in excess of 400% of their net worth. While overseas investment up to 400% is under the automatic route, investment in excess of 400% will need prior approval of the Reserve Bank of India. This should help Indian outbound investments, specifically in the upstream oil and gas and mining sectors.
- The Indian government has relaxed external commercial borrowing ("ECB") norms, and now allows companies to undertake borrowings of up to US$50 million (earlier permissible limit US$20 million) for incurring rupee expenditure for permissible end uses under the Reserve Bank of India's Approval Route. In the case of borrowers in the infrastructure sector, the limit has been fixed even higher at US$100 million.
- As anticipated, the guidelines for easing foreign investment in key areas such as commodity exchanges and credit information companies ("CIC") have been finalised. Overall foreign investment of up to 49% is permitted in commodity exchanges, with specific prior approval of the government. However, investment by way of FDI is limited to 26% and by FII is limited to 23%. Overall foreign investment of up to 49% is permitted in CICs, with specific prior approval of the government and clearance from the Reserve Bank of India. However, investment by way of FII is permitted up to 24% only in CICs listed on the stock exchanges.