Healthy capital cushion points to future growth

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Any discussion of outbound investment from India must begin with the effects of the 60 hours in Mumbai last month. The psychological effect of such a devastating event and its commercial impact is all too familiar for those of us who lived through the 9/11 attacks in New York. But neither the cloud of diffused political violence nor the global credit crisis of 16 months has significantly deterred internal growth in India.

The immediate effects of the Mumbai attacks cannot be underestimated but the consensus on the long-term fundamentals of investments into and out of India continues to remain robust.

Although the increasing rate of foreign direct investment (FDI) into India is under siege, the country continues to attract capital searching for a growth economy. The Indian prosperity this FDI has fuelled, or benefited from, has also generated a sustained level of capital accumulation in India over the last 10 years. It should come as no surprise then that India Inc has a healthy capital cushion, even as alarms of liquidity constraints fill the air.

As valuations in the West have taken the steepest decline in a quarter century, Indian businesses continue to look for opportunities to expand. Even if this does not translate to activity at a level seen in 2007, when India purchased a total of US$32 billion of foreign assets – twice as much as the total inbound acquisitions – there will be sustained outbound activity from India as Indian businesses look to rationalizing and expanding their market reach.

There are bargains galore in the West today, especially in the US. FDI inflow into the US, at US$204.4 billion in 2007, was at its highest since the economic downturn in 2001, and represented an average annual increase of 88% since 2005.

However, arguments persist that the slowdown in the global markets will restrict the inflows of capital into India and, in turn, force a slowing economy to be less concerned with outbound investment. Unfortuntately this does not seem to be borne out in the data. A recent report by the European Central Bank concluded that a 1% decline in US GDP growth drives a 0.1-0.5% decline in Asian GDP. Even a 2-3% decline in growth in the West would seem to have a negligible impact on India's projected growth rate of 5-7%. So, if India remains robust, where will opportunities lie for those looking West?

The most intriguing aspect of the growth in Indian investment into the US has been its character. Twenty years ago, resource-constrained Indian manufacturers in industries such as textiles and basic commodities, faced with creeping domestic demand, looked to US investments as trading opportunities to drive better cost margins. Today, many Indian companies with domestic capacity demand are determined to expand their global market reach. Vertical integration, supply consolidation and value chain leveraging – all hallmarks of strategic growth players – are driving Indian M&A activity in the US.

Luckily this shift in power and priorities has occurred just as opportunities to expand into the US have presented themselves, particularly within complex, regulated industries. The valuation declines caused by tightening liquidity in the US have been especially steep in highly leveraged, capital intensive sectors such as financial services, natural resources, pharmaceuticals, heavy manufacturing and even media. The regulatory architecture defining these industries is a challenge for Indian investors and strategic buyers looking to exploit current opportunities.

Product value-chain transactions to acquire premium brands have received significant attention. From the Tata Group's creation of luxury brand properties such as Taj Boston and purchase of the Jaguar and Land Rover brands, to Wockhardt's acquisition of Negma Laboratories – these acquirers have sought to increase their global footprint and geographic penetration. But business headlines fail to appreciate the vast US regulatory maze that foreign investors must manoeuvre and master in trying to globalize their asset base.

Even sophisticated foreign strategic buyers with a wealth of global experience are unprepared for the complexities posed by these regulated sectors. For instance, there are no primers in the global pharmaceutical industry that can prepare any acquirer to adequately value the legal and business risks of patenting, testing, licensing and marketing of any new drug assets of a US target under the Food and Drug Administration regime.

The coming US administration may well determine the direction in which the executive branch will wield the power of the interagency Committee on Foreign Investment in the US (CFIUS). As increased governmental attention to national security issues has resulted in closer scrutiny of FDI, the CFIUS process has become a critical consideration in the acquisition of US assets by foreign entities. Whether the Obama administration will use it as a protectionist agenda to curb FDI in a distressed US economic environment remains to be seen.

Nevertheless, buying opportunities in value accretive properties in the West for Indian investors will remain strong in the regulated industries and will only increase as the economic slowdown in Europe and the US deepens.

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