



# India

Record levels of deal activity set the scene for a landmark M&A year

## Current Environment

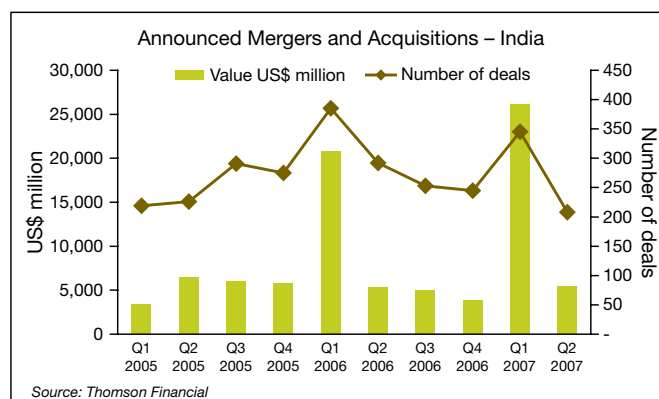
The Indian economy grew at 9.4 percent during the fiscal year end March 2007 (2006-07), its strongest performance in the last eighteen years. This was possibly on account of strong performance by the industrial and services sectors, both of which grew approximately 11 percent. The industrial sector growth was fuelled by the manufacturing sector, which grew at over 12 percent, and the services sector which grew at over 13 percent on account of the growth in trade, hotels and transport segments, apart from the IT sector. While the growth was commendable, it fell short of that which appeared possible earlier in the year, primarily on account of the sharp decline in the agricultural growth rate, to 2.7 percent.

Inflation of over 4 percent and the steadily widening current account deficit are the other key concern areas for the Indian economy. The good news however has been that these are known challenges, and the Government has been working on them. In the fourth quarter of 2006-07, the current account deficit turned positive by US\$2.5 billion, thereby reducing the overall current account deficit from US\$12.1 billion to US\$9.6 billion. Significantly, no newer macro economic challenges emerged during this period. The Finance Minister, Mr P Chidambaram, in his budget blueprint for 2007-08, focused on improvements in the agricultural sector and increased investment in infrastructure, and the overall sentiment has been positive.

All of the above resulted in an increase in business confidence levels, and made global investors keener on India. This resulted in increased levels of foreign direct investment (FDI), which went up to US\$19 billion in 2006-07 – almost 75 percent higher than the US\$11 billion of inbound investments in 2005-06. This is the highest FDI equity inflow into the country during any financial year since the commencement of economic reforms. This result is all the more remarkable in light of recent regulatory amendments, relating to in-bound investments by way of non-convertible instruments. Those changes effectively treat such investments (eg debentures and preference capital) as external commercial borrowings, thus limiting the return on investment for investors and also imposing end-use restrictions on investees.

The bullishness of financial institutional investors and the rise in FDI investments resulted in India's foreign exchange reserves increasing to over US\$190 billion for 2006-07. Based on these trends, the Commerce and Industry Ministry expects FDI flows in the current fiscal year to touch US\$30 billion.

## Deal Activity



India witnessed heightened deal activity in the first half of 2007, with the combined value of domestic and outbound M&A transactions crossing US\$55 billion spread over 553 deals, far exceeding the total deal value recorded for the whole of 2006. Notable amongst deals during the period were the sharp acceleration in outbound activity by Indian corporates, and significant growth in private equity investments in the country.

Outbound investments, which included Tata Steel's US\$13.6 billion acquisition of Corus and Hindalco's US\$6 billion acquisition of Novelis, exceeded US\$28 billion. In a way, these two large deals have brought Indian M&A to the global forefront – India's outbound M&A during the first six months of 2007 was second only to Australia. It has also broken the myth that Indian businesses are all about IT and outsourcing, as most of the outbound M&A was by companies belonging to the traditional old economy sectors. Sectors such as energy, oil and gas, steel, cement, aluminum and other metals accounted for over 50 percent of total deal value, compared to just 20-25 percent of the deal value a couple of years ago. This is reflective of the fact that Indian companies in these sectors are looking to be competitive globally and not seeking protectionism. A number of these deals were debt funded, highlighting the tremendous confidence that the Indian and overseas banking and finance community has in the Indian companies and their ability to make these acquisitions work. Some of the other key out-bound deals reported during this period included the following:

- Tata Power's acquisition of PT Kaltim Prima Coal and PT Arutmin Indonesia for US\$1.1 billion. This deal has given Tata Power access to one of the largest exporting thermal coal mines in the world
- Essar Steel's acquisition of Canada-based integrated steel producer Algoma Steel Inc. for US\$1.58 billion
- United Spirit's acquisition of premium scotch distillers Whyte & Mackay, Scotland for US\$1.17 billion
- Suzlon Energy Limited's acquisition of a 74.6 percent stake in RE Power Systems AG, the German manufacturer and supplier of wind-powered generating facilities for US\$1 billion



- Sun Pharmaceuticals acquisition of Israel's generic manufacturer Taro Pharma for US\$446 million, making it the second largest overseas acquisition by an Indian drug company

Whilst outbound deals were clearly the flavour of the season, domestic and in-bound investments also scaled new peaks for any first half on record. The most significant of these was Vodafone's acquisition of a 52 percent stake in India's fourth largest mobile service operator, Hutchison Essar, for a consideration of US\$10.9 billion. Other key deals were as follows:

- Vedanta Resources Plc, acquired a 51 percent controlling stake in Sesa Goa for approximately US\$981 million
- Mittal Investment's (a wholly-owned unit of Arcelor Mittal NV) acquisition of a 49 percent stake in oil and gas refinery, Guru Gobind Singh Refineries Ltd, for approximately US\$747 million
- Matsushita Electric Works' acquisition of an 80 percent stake in India's oldest and largest electrical accessories and wiring devices company, Anchor Electricals, for a consideration of US\$420 million
- Jet Airway's acquisition of Air Sahara for approximately US\$339 million

The domestic deal activity during the period also highlighted consolidation, notably in the telecom and aviation sectors. The Vodafone – Hutch transaction signaled the commencement of what should be the last phase of consolidation in the Indian telecom space; likewise the Jet – Sahara and the Kingfisher – Air Deccan deals signified the consolidation of the Indian aviation sector, which has been struggling for a bit.

Private equity investments have also been rising steadily, with over 200 deals during the first half of 2007 – in value terms, the private equity deal activity crossed US\$6 billion, compared to the US\$7.9 billion for the whole of 2006. There has also been a shift in sector focus by private equity, with industries such as real estate, banking and financial services, media and entertainment witnessing tremendous growth in investment, vis-à-vis traditional sectors such as IT and ITeS, pharmaceuticals and healthcare, and telecom. For instance, investment in banking and financial services accounted for over 20 percent of total private equity investment in H1 2007 vis-à-vis just 7-8 percent in 2005 and 2006. Some of the notable private equity deals during the first six months of 2007 include:

- Carlyle Group and Citigroup Inc invested US\$786 million for a 7.11 percent stake in Housing Development Finance Corporation Limited
- National Stock Exchange (NSE) and Bombay Stock Exchange (BSE), two of the biggest stock exchanges in India, saw private equity firms pick up stakes in them following the change in FDI norms. NYSE Group Inc, Goldman Sachs Group Inc, General Atlantic LLC, and Softbank Asian Infrastructure Fund, invested approximately US\$500 million in NSE for a 20 percent stake. Deutsche Bourse and Singapore Stock Exchange each picked up a 5 percent stake in BSE, wherein each party paid an amount of US\$42.7 million

- US based hedge fund, Avenue Capital Group, invested US\$500 million in SKIL Infrastructure for a 26 percent stake
- Blackstone Group acquired a 26 percent stake in Ushodaya Enterprises Ltd, a television station owner and operator, for US\$275 million, and invested an amount of US\$200 million for an 80 percent stake in Intelnet BPO
- In one of the largest FDI deals in Indian realty, Morgan Stanley invested US\$152 million in Oberoi Constructions, a real estate development firm for a 10.75 percent stake

Private equity and venture capital funds continue to focus on India in a big way, in spite of some valuation concerns in recent times. The growth in private equity investments during this period is even more remarkable, as it comes during a period when the Government restricted the income tax pass-through available to Indian registered venture capital funds to investments in specific sectors such as infrastructure, biotechnology etc. While this did dampen the sentiment for a while, alternative structures are already being worked out, and this is not expected to have a material impact on private equity / venture capital investments in India.

## Outlook

M&A activity is expected to remain on an uptrend in the second half of 2007, and the dominance of cross-border deals is expected to continue. Consistently strong economic growth, combined with continuation of the reform process and improvements in infrastructure by the Indian government, is likely to boost FDI too, but significant policy changes appear unlikely. Segments where an FDI cap is expected to be relaxed further include petroleum refining (from 26 percent to 49 percent) and civil aviation businesses, such as ground handling, maintenance and repair, and air charter services, where up to 100 percent foreign investment is expected to be permitted, against 49 percent at present. The Indian government is also expected to finalise the guidelines to allow up to 49 percent foreign investment in commodity exchanges, a move which is expected to result in significant investments.

Further liberalisation of the FDI regime is also expected with a plan to exempt several sectors from the mandatory requirements under Press Note 1 (PN 1), which requires multinational corporations in existing joint ventures to obtain no-objection from its Indian partners before starting another venture in a similar line of business. Sectors such as advertising, hospitality and franchisee operations are being considered to be kept out of the purview of PN 1.

Private equity and venture capital investments are expected to rise even further, and exceed US\$10 billion in 2007. While there have been some valuation concerns within the private equity community, the sequential growth experienced by the Indian economy has meant that the private equity investors have stayed interested. Consumer facing businesses, including retail, which ride on the growing consumerism in the domestic market are expected to be favoured by them, together with power equipment, healthcare, entertainment and media and the banking and financial services sectors.