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In India, the Gap is the Potential

It's a good time to be in India!

Western businesses are increasingly looking to enter India or to scale their operations there:

- they need to follow their clients who are also going to India;
- they want to generate new growth by tapping the immense potential of India's domestic market;
- they need to add capacity to their existing production resources;
- they want to build a low-cost export base.

India's economy is diverse and growing very fast, but there are still huge gaps to be filled in terms of availability and quality of even basic goods and services: The gap is the potential.

simple and "ruggedized" solutions are required to meet the basic needs of the population

The real problem in India is basic infrastructure and there is a huge gap between the haves' and the have not's'. Seventy percent of India live in the country side where there is a scarcity of proper electricity, roads and in some places even water. This creates a need for simple and "ruggedized" solutions to meet the basic needs of the population: Logistics and cold storage to bring perishable commodities from the first mile to the last mile is still a challenge. This challenge results in a huge earnings gap between the farmer and the end retailer – at the farmers' expense Agricultural production has seen a decline over the years on this account.

Renewed Opportunities for Western Investors

This creates a very large opportunity for western players being able to offer technology, know-how and equipment to the Indian market: The Indian economy offers investors exposure to a wide range of opportunities from consumer goods and pharmaceuticals to infrastructure, energy, agriculture, and of course knowledge-based services (IT, software, business services).

India's growth scenario is very robust

India's overall growth scenario is promising: In Purchasing Power Parity terms, which recognizes India's low cost base, GDP is at US$3.8 trillion (twice as much as Germany's GDP) and, by 2013, it will become the third largest economy in the world after the USA and China. We believe that India's growth scenario is very robust, thanks to a series of factors:

- India is a consumer market in its own right. India's domestic consumption, generally led by the private sector, has played a significant role in India's growth and is expected to remain firm as more people enter the workforce and the emerging middle classes. However, as exemplified by the low performance of west-

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ern luxury goods manufacturers, India is primarily a market for domestic or localized products.

- This creates the need for a combination of western novelty, quality, know-how and local adaptations. Global consumer goods players such as L'Oreal, Nestlé or McDonald's have massively customized their products and packaging to successfully meet the needs of the Indian population.
- India's wealthiest consumers (those earning US$1m or more in PPP terms) will increase by 40 million in the next 10 years. This leads to increasingly segmented markets where various quality levels coexist, responding to the needs of differentiating customer groups. The automotive industry is a good example where component providers are increasingly asked to provide western-quality components alongside "Indian-quality" products meant to meet the needs of a low-cost / low-price market.
- India is one of the world's youngest countries, with an average age of 25. India's working-age population will increase by 240 million over the next 20 years. The population will remain young for many decades while China's population is about to start ageing. Driven by increasingly modern marketing and advertising, consumption is on the rise, now also in medium and small towns, and the need for household, lifestyle and leisure products is growing at a fast pace.
- Statistics have shown that India is moving towards consumerism. India has jumped and leap-frogged some technologies and adopted new ones at an amazing pace. The transition from CRT televisions to LCD and LED TVs happened in 3 years! India did not go through the Plasma TV generation at all and adopted the new technology instantly. Similarly, the cellular phone market has revolutionized the country. India has the cheapest rate for cell phone tariffs anywhere in the world. India did not experience a transition via the Pager market. This provides potential for GSM-based solutions such as payments, ordering and supply chain, mobile banking, credit and insurance… Banks are heavily investing in building the channels to offer such services to erstwhile unserviced populations.
- India has a robust, transparent, and well regulated financial system which has shown its strength in weathering the global financial crisis. The banking sector shows top quality balance sheets, high levels of competition (there are around 80 banks in India) and strong corporate governance. However, a large portion of the Indian population remains un-banked and there is a lot of room for additional services (investment, insurance etc.) for the already banked population. This again creates scope for robust growth and partnerships with foreign players.
- There are 45 million entrepreneurs in India, driven by an exceptional optimism and energy. One can find an abundance of Indian ex-

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ecutives with experience in international businesses, particularly in the USA.

There are three main routes for Western Companies to grow in India:

1. Going Greenfield
2. Acquisition of an existing business in India
3. Joint ventures with an existing player in India.

There are both advantages and disadvantages in the three approaches. In this article however, we focus on acquisitions while joint ventures will be focused on in a later article Acquiring an Indian business has the advantage of giving the buyer a head start in the market. It also prevents the western player from enduring the pain of building a business from scratch (finding and buying land is just an example of what "the pain" involves).

Indian M&A on the rise

2010 has seen a rebound in M&A activity in India (cp. fig. 1). This is due to Indian businesses streamlining and reorganizing their portfolios after several years of opportunistic growth, to consolidation in sectors such as IT Services, telecom or pharmaceuticals, to Private Equity firms initiating exits on some of their portfolio companies, to the Indian Government divestment of state-owned assets, and to cash-strapped companies reorganizing their assets.

Cross-border inbound deals are also on the rise as current valuations are getting more realistic and attract foreign players willing to establish or grow their presence in India.

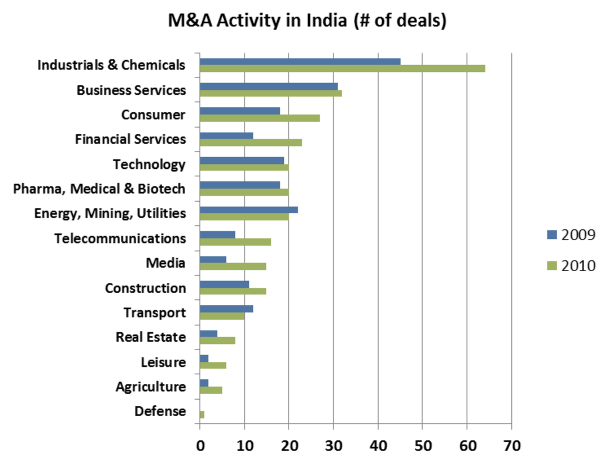

Figure 1: Indian M&A activity 2009-2010

Finding the Right Targets

It is not always obvious to find "suitable" acquisition targets and one will need to conduct in-depth market investigations to find the right acquisition partner:

- In sectors such as technology, IT services, engineering design, BPO, one can rather easily find partners to create capacity that will be upgraded in the future. However, only a few high-quality players are still independent and this may be reflected in high valuations.
- In some cases, because of the gap/opportunity mentioned above, acquired companies will require substantial post acquisition upgrades. This is often the case in industrial sectors where Indian manufacturing standards are not always up to international standards. This re-

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flects both the opportunity to better position products in India and the challenges faced in post-merger integration where technology, manufacturing processes and management skills may need to be reorganized.

- Financial transparency is not always granted and one needs to identify acquisition candidates with sound financial and management processes. Companies within well known Private Equity portfolios are usually "safe targets".
- In a limited and decreasing number of sectors (Defense, Retail…), foreign direct investments are either limited or prohibited. The trend, however, goes towards a larger number of "automatic route" sectors where no regulatory approval is required.
- Some Indian business owners may adopt conduct a staged-approach to maximize their earnings: In this approach, they will initially try to sell a small part of their business and to sell the balance shares at a higher price. We strongly advise against such deal structures, since they mostly end up with both parties disappointed.

Valuations can be high

Indian enterprise values can be very high and may sometimes be considered as unrealistic by foreign buyers. This is reasoned by Indian shareholders optimistically comparing their own companies with highly overrated ones. Also, businesses are often valued on very high growth scenarios (usually above 10% per annum, even business plans showing 20-30% y-o-y growth for the next 5 years are not rare).

In recently conducted transactions, P2P Consultants sometimes had to deal with sales multiple valuations ranging from 2x to 2.5.

Finally, Indian promoters may consider that the opportunity to enter India through acquisitions is attractive enough to make foreign companies pay nearly any price.

Implementing an acquisition in India: Cultural aspects

The steps to be followed to acquire a company are the same as in the west. However, cultural aspects will play an important role in conducting a successful acquisition. This includes several aspects:

- **Dealing with the "promoter"** - A very large proportion of Indian businesses are owned by a "promoter" family which has an enormous influence on the governance and decision-making processes. Business decisions, including the sale of the company can be highly influenced by emotional considerations such as jobs for the family members, future influence on decisions by family members, board seats, etc. Western businesses may find it difficult to deal with the promoters and find the governance opaque or "unprofessional". However, one should show flexibility since these cultural aspects are also a guarantee that the promoters will support the company in difficult times and will ensure similar support from their

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family and business networks. Barring a few large industrial groups many Indian companies are run like family businesses. While this may seem odd to the western world, they still run extremely efficient. This legacy comes from the fact that when the British left India in 1947 they handed over many of their companies to trusted Indian employees; over time their families took them over and ran them. Today, many of the companies which are seemingly "family" run are listed, have a Board of Directors, and have proper Corporate Governance etc. You may still find a few family members on (the) Board!

- **Dealing with time** – Negotiations may take long, as it takes time to build trust: While one can close a business deal in a few hours in the USA, in a few meetings in Europe, it may take many more meetings, many of them seemingly "useless" and spent exchanging general views, to close a deal. "Putting pressure" on a deal to accelerate closure may prove counter-productive. The time to negotiate and close a deal gets longer as you move east, as most time is taken in Japan! In India however, the business-building factor is trust. Therefore the long times are taken to better understand the other party and to see whether they are worthwhile to do business with. In the end, it is the combination of commercial and cultural fit that closes the deal.
- **Dealing with "No"** – Bringing a negotiation to an end is not always easy as it may take parties to say "no" to each other. Indian society is not very prone to saying "no" as it may cause disappointment or offense. It is not rare to see an Indian Party trying to renegotiate a deal before signing, even if it is considered as closed. However, once signed, the deal is binding to all parties.

Conclusion

Entering India through acquisition comes with a huge potential as this is often the best way to jump start an operation in India and to initiate operations with a "culturally-ready" company. However, successfully conducting acquisitions in India will also require careful execution so as to select the right partners, pay the right price, and overcome cultural barriers. It is advisable to work with experienced specialists.

By Francois Montrelay and S. Devarajan

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