Inbound and outbound deals

Their oyster, with grit included

Cross-border deals involving Indian firms have been more famous than profitable

IN THE SOUTHERN state of Kerala earlier this year a treasure was discovered in a temple. Hidden in secret vaults for hundreds of years, it is thought to be worth many billions of dollars and includes coins from the Roman empire, Venetian ducats, **16th**-century Portuguese money, **17th**-century Dutch East India Company currency and even the odd nugget or two from Napoleonic France. "The find is like an economic history of India unfolding," says Gurcharan Das, a writer and former boss of Procter & Gamble in India. For most of its history the subcontinent was open to trade and the outside world. The insularity and protectionism of the **1947-91** period was, he says, "an aberration".

When it comes to trade, India is still not as open as China. Exports, and not just software and outsourcing, are however growing fast and there are signs that India is gaining traction as a manufacturing centre. Bajaj Auto, a family firm, for example, exported almost **1.2m** motorbikes and three-wheelers in the year to March **2011,** with about half going to Africa and the Middle East. For all that, though, most Indian firms are making their mark not by trying to be the workshop of the world, but by aspiring to be multinationals: active, in control and physically present in lots of countries, doing everything from development and manufacturing to branding and distribution. They are doing all this far earlier than firms in other emerging countries would dare.

Indian bosses, a sophisticated and worldly bunch, have a huge cultural head start, as anyone who has witnessed a Chinese state-owned firm trying to charm the outside world can testify. They are sometimes said to have other advantages, too; Indian firms can handle diverse workforces, for example, since they already do at home. The most breathless strain of this argument is that if you can make money in India you can make it anywhere. Indian firms, it follows, are destined to rule the world.

That last claim is silly. Indian firms also face formidable disadvantages. One is their size: they are middleweights by international standards. Their fiddly holding chains make it hard for them to pay for things by issuing shares, and their cashflows can be thinly spread across many subsidiaries. Raising debt in India to buy things abroad is expensive, with base interest rates approaching **9%,** and difficult because the central bank frowns upon it. Indian firms raising funds abroad are hobbled by the country's poor credit rating. India does have large foreign-exchange reserves, but these are not recycled as cheap foreign-currency loans to fund corporate adventures, as they are in China. T.C.A. Ranganathan, the boss of Export-Import Bank of India, a state body aimed at financing trade, says it simply does not have the same risk appetite as its Chinese equivalents.

These factors help explain why the first wave of takeovers abroad by Indian firms, between **2004** and **2008,** took such a peculiar form (see table). A product of the debt bubble, they were leveraged buy-outs in all but name, from Tata's trio of deals to those undertaken by Hindalco (part of the Aditya Birla Group) and Suzlon, a wind-turbine firm. These firms used money borrowed largely from Western banks and money markets, in some cases secured only against their targets' cashflows. As the crash in the West began, their refinancing options dried up and the target firms' profits slumped in most cases.

Things looked pretty bleak. Ishaat Hussain, the finance director of Tata Sons, recalls the group being battered and putting a programme in place to raise spare cash. Tata Motors' vice-chairman, Ravi Kant, says the combination of a deal and a financial crisis "put great stress" on the carmaker. At one point it asked the British government for state aid. Smaller firms that had followed the leveraged buy-out path got whacked, too. Havells, an electronics and consumer-goods outfit, bought Sylvania, headquartered in Frankfurt, in **2007,** but by **2008** its London bankers threatened to pull the plug. Everything was on the line, recalls Anil Gupta, its joint managing director: "The family's reputation, our business's reputation and our personal reputations."

His firm toughed it out and emerged stronger. Tata and Aditya Birla did too, though their subsidiaries Tata Motors and Novelis are still viewed as risky bets by debt investors. Suzlon, once a darling of investors, had to restructure part of its debt. Mere survival, however, is not the point of takeovers. The real test is creating value. Tata has done very well on **J L R** but most analysts reckon it overpaid on its larger deal for Corus. Last year Novelis failed to cover its cost of capital, though Mr Birla is optimistic. From a shareholder's perspective Suzlon has been a disaster. Indian bosses tend to argue that they are building for the long term and hint that return on capital is for wimps and nitpickers. Many Indians are also intensely patriotic about these deals. But at some point a more sober judgment must be struck.

The leveraged buy-out approach may already be fizzling because the generous debt terms that it relied on are no longer available. Mega-takeovers are likely to be the preserve of big, cash-generative groups with simple structures. One such firm, Reliance Industries, is on the prowl, though its proprietor, Mukesh Ambani, is thought to be impressively stingy about deals. Bharti Airtel took the leap in **2010,** paying **$11** billion for Zain, an African mobile operator. The acquisition makes strategic sense but unfortunately looks like another case of overpayment, particularly because Zain's profits have since disappointed.

For the many other Indian firms without giant resources and a taste for Russian roulette, a more nuanced approach to dealmaking abroad beckons. In a continuation of the vertical-integration habit, Indian firms have spent billions buying up coal

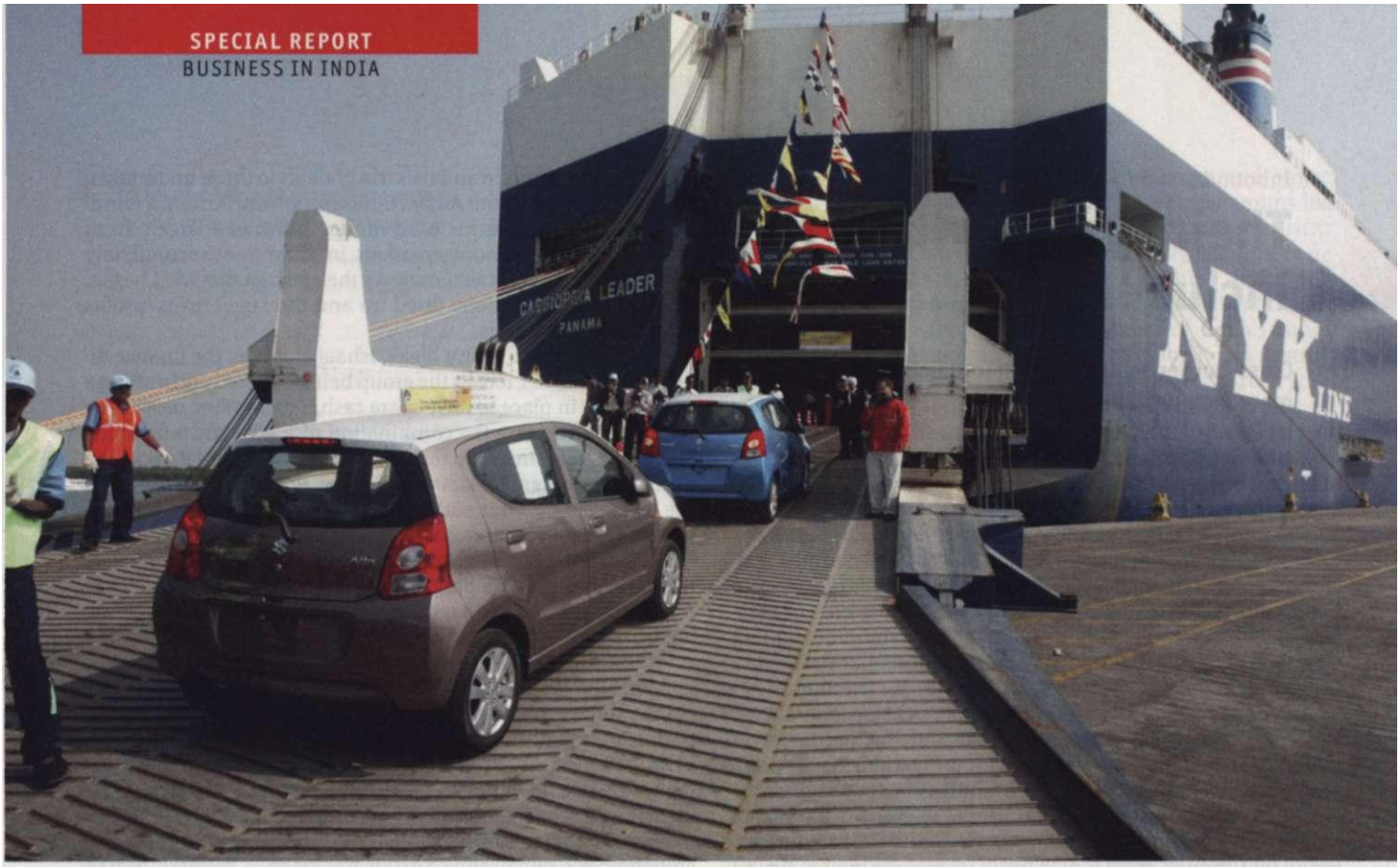
Cross-border, cross shareholders 5

Largest Indian cross-border deals, **$bn** *(year)*

FOREIGN Buyer	→ INBOUND	INDIA Target	INDIA Buyer	OUTBOUND →	FOREIGN Target
Vodafone: **18.6** *(2007)* *Overpaid. Writedown after price war and tax spat*	→	Hutchison Telecom	Tata Steel: **13.0** *(2006)* *Impressive ambition, bad timing. Paid too much*	→	Corus
BP: **7.2** *(2011)* *Will BP's help increase output?*	→	Stakes in Reliance Industries' offshore fields	Bharti Airtel: **10.7** *(2010)* *Early days but looks pricey. Zain has since stumbled*	→	Zain Africa
Daiichi Sankyo: **4.6** *(2008)* *Fiasco. Shares worth less than half purchase price*	→	Ranbaxy Labs	Hindalco*: **5.7** *(2007)* *Recovery under way but yet to cover cost of capital*	→	Novelis
Vedanta: **4.5** *(2011)* *Oil deal bogged down in red tape for a year*	→	Cairn Energy India	ONGC: **2.6** *(2008)* *Production has missed targets since the deal*	→	Imperial Energy
Abbott Labs: **3.7** *(2010)* *Bold strategic move, scary valuation*	→	Piramal Healthcare	Tata Motors: **2.3** *(2008)* *Great deal, has confounded the critics*	→	Jaguar Land Rover
NTT DoCoMo: **2.7** *(2008)* *Terms unclear, but Tata's mobile arm is struggling*	→	Stake in Tata's mobile business	Abbot Point: **2.0** *(2011)* *Secures coal supply with export hub in Australia*	→	Mundra Port†

Sources: Dealogic; Bloomberg; Company reports

*Aditya Birla †Adani Group



Made in India

- resources in Australia and Indonesia. They may have to compete against undisciplined Chinese buyers and there are worries about political risk in Indonesia, but in the main these deals make sense given the shortage of domestic production.

Another emerging trend is that of the "pocket multinational", which uses a series of smaller bolt-on acquisitions to build up its presence abroad. These can provide access to new products, technologies and markets, but without an all-or-nothing gamble. Crompton Greaves, part of the Avantha group controlled by Gautam Thapar, underwent a strategic review in **2001-02.** "The results were sobering," he says. In response it made a succession of foreign deals, mainly in Europe, in its area of electronics and engineering, with the main aim of gaining know-how and better products. With a total outlay of some **$250m** these deals made a decent return on capital last year, though trading has since been hit by the euro-zone crisis.

Godrej, a family conglomerate whose biggest line is consumer products, is another exemplar of this approach. Although not closed to the idea of a large transformational acquisition, Adi Godrej, its boss, says the firm was too disciplined during the boom. Instead of betting the farm it spent about $1billion on a series of small purchases in niche areas, such as an Indonesian firm that makes household products including insecticides and air-fresheners, and a South African maker of hair products. Mr Godrej says it is taking a hands-off approach to managing these businesses and that the acquisitions have all made fair returns.

In most cases the aim of such deals is to marry the savvy Indian approach to things like working capital with the acquired firms' managers, technology and products. The danger is that the acquiring firms are spreading themselves too thinly, creating the overheads of a global company without the corresponding sales. Still, it is an approach that is gaining popularity, with Infosys recently emphasising that it would consider bolt-on deals. The technology firm also provides a good example of a third international expansion strategy, that of going abroad without deals, but simply starting new operations in other countries. Infosys now has quite a big operation in China, for example. S. Gopalakrishnan, its chief executive, says it has been successful in recruiting Chinese talent and has done well at winning business from the Chinese subsidiaries of multinational clients. But it is still hard to sell to Chinese firms themselves, he says.

History suggests that building a multinational bit by bit and eschewing giant, high-risk deals is the best way to create a durable firm without wasting money. But it takes time, and India Inc has been in a terrible hurry. With financing conditions now tougher and some hard lessons learned from the first round of Indian takeovers, a more measured approach is likely in future. Just the kind of approach, in fact, that mature multinationals from the rich world, with decades of experience under their belts and world-class advisers, take when viewing new markets like India, right? Not quite. Foreign firms that have expanded into India have had their share of problems, too.

A land of milk and honey

R.C. Bhargava can still remember the day the Maruti Suzuki factory in Delhi started churning out small cars in **1983.** To the amazement of the newly hired Indian workers, the Japanese supervisor said the plant had to be spotless first and, picking up a mop, got to work. "We decided from the start that we had to compare ourselves with the best in the world," Mr Bhargava says. That included tea breaks exactly seven and a half minutes long. Today he is chairman and Maruti Suzuki is one of India's most successful foreign-controlled firms, with about half a billion dollars of profits last year. Still, during **2011** it has suffered a wave of strikes in its factories. Even three decades on, the going isn't easy.

If India is, as the cliche goes, a land of contrasts, then the biggest may be that between the bosses of firms the world over who are crazy about India, and their staff on the ground, who have often become professional eye-rollers. Corruption, sloppy standards, a lack of decent staff and red tape are the main gripes.

Many say Indian business culture, while beguiling, is less accessible that it first seems. Hierarchies can be rigid. And deals get done through informal networks. For all that, however, their bosses at home are often mustard keen, tantalised by projections that show India is too big to ignore, with the world's biggest and youngest pool of labour and a growing middle class.

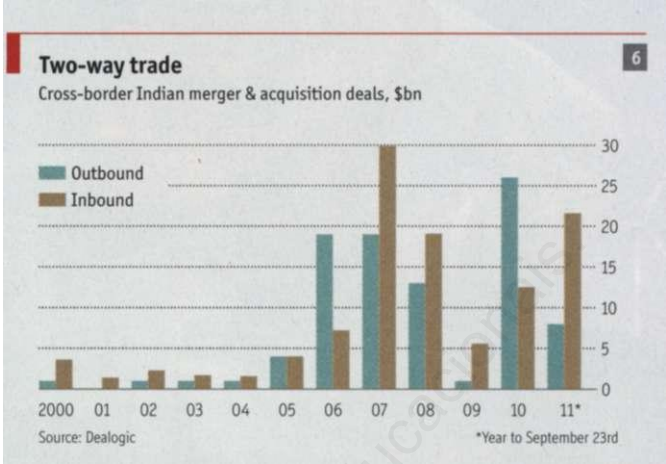
Tapping into the first attribute, India's labour force, has so far mainly been the preserve of the technology industry. Following the lead of India's outsourcing firms, **I B M** , for example, has gradually built up a workforce of over **100,000** in India, a big chunk of whom serve its clients abroad. But beyond outsourcing, using India as an export base tends to be hard work indeed. Capital-intensive projects are formidably tricky to get started. Posco, a South Korean steel firm, announced plans for a **$12** billion investment in a factory in Orissa, an eastern state, in **2005,** aimed both at meeting domestic demand and producing for export. Today work has yet to begin and the plan is still in limbo. The long squabble seems to have involved every part of India's government and judicial apparatus.

Carmakers are the great exception, but they come with a twist. Maruti exports just over a tenth of its production, mainly to Europe. Hyundai, a South Korean firm and the biggest exporter by volume, sells a fifth of its production abroad, says Arvind Saxena, a director of the Indian arm. Clusters of expertise exist in the states of Tamil Nadu and more recently Gujarat, where most car investments now tend to go, thanks to welcoming local officials. Foreign car firms source almost all their components locally. Hyundai India led the way for **70**-odd Korean suppliers who have invested some **$70om** in facilities around its plants near Chennai. The level of research and development by foreign car firms in India is still puny, but in time that should come too.

What India does not seem to give foreign firms is a clear-cut cost arbitrage over other places in the world, despite its vast and cheap labour force. Other inputs such as electricity can be costly and unreliable. Tricky logistics also make a difference. To get its finished cars to Chennai's port, Hyundai has to pack them onto trucks that rumble through the city centre every night during the small hours. It reckons its Indian factories make vehicles at a similar price to its plant in Turkey, once trade duties are included.

For foreign carmakers it only makes sense to export from India products that you are also selling there, to piggyback off the economies of scale that India's big domestic market creates. Small cars are a great example. The hitch is that the products made in India have to be good enough and similar enough to be attractive to the rest of the world. That isn't always a given.

"I remember sitting in a remote village with a man who was tasting cola for the first time. He spat it out and said, 'this tastes like medicine'," recalls Ashok Kurien, then a marketing guru and now an entrepreneur. "I realised you couldn't sell a cola in this country on taste." His solution was an advertising campaign for Thums Up, a local cola, under the slogan "Taste the Thunder", that tapped into the average Indian's fears and yearnings as the economy opened up in the early **1990s.** It was so successful that The Coca-Cola Company eventually bought the drinksmaker and tried to replace the local brand with its own global one. The result was an outcry, and the American firm had to backtrack. Today Thums Up, owned by Coca-Cola, is still in rude health, and keeping dentists busy.



If manufacturing in India is hard for foreigners, building a customer-facing business is no walk in the park either. India has been a success story for Nokia, Finland's handset giant, and remains its second-biggest market and a big manufacturing base. But sales there have declined since **2008,** paradoxically reflecting both its lack of high-end devices to rival the BlackBerry and the iPhone, and its lack of low-end ones, such as phones with dual **SIM**-card slots that penny-pinchers use to surf between networks. To compete in India you need one eye on the world and another on the street.

Ask a street vendor for a "Cadbury" and you'll be given a chocolate bar. That's real distribution and branding power, but it has taken a long time to build. The confectionery firm (originally British and bought by America's Kraft in **2010)** has been in India since **1948.** Its local bosses are Indian. It belongs to a select group, including Maruti Suzuki, of firms that have been in India for the long haul, mainly employ locals and seem to have developed deep competitive strengths. Many have listed local subsidiaries. Siemens, Germany's industrial giant, has been present in India for almost a century and now makes nearly $3 billion of sales there. It will soon employ four foreigners for every **1,000** locals.

Hindustan Unilever, the local offshoot of the consumer-goods giant, makes half a billion dollars of profit a year and is one of the most prestigious employers. It takes reinvention seriously. "We need to innovate constantly," says its boss, Nitin Paranjpe. "If we obsessed about minimising risk we'd do nothing." The largely indigenised foreign firm prospers in banking too, with India's biggest foreign lenders-Citigroup, **H S B** c and Standard Chartered-having pedigree there. For all these firms their Indian units have gone from being backwaters to growth engines for their parent companies and sources of talent. Eventually some of these firms will be run by Indi-

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• ans who earned their spurs in the subcontinent-so far, most of the handful of Indians who've made it to the top of global firms emigrated from the mother country when they were fairly young.

That success in India just takes time is not a message other foreign firms like to hear, though. Many have gone for the blunderbuss approach, with big upfront investments in distribution to try to win market share quickly. This often gets messy. More than ten foreign life-insurance firms have rushed into India, all with local partners. At their peak, before the **2008** crisis, they employed armies of agents to sell savings products, often unprofitably, sometimes illegally. The industry has since shrunk and been clobbered by regulators, and some foreigners are expected to exit. It was a "mindless chase for the top line," says one boss, "a completely reckless expansion". Chinese firms have their own kind of land grab. Shanghai Electric has won big contracts to build power stations in India, aided by a big slug of subsidised vendor-financing from state-backed banks to the Indian buyers.

Gently does it

For those who just can't wait, the only real option to achieve immediate scale in India is the takeover. But since most assets are in hot demand, the results of foreign deals in India have been iffy. Vodafone has already written down its purchase of a controlling stake in India's second-biggest mobile firm after a price war, a legal tangle with its India partner and an unforeseen tax claim by the government. Japan's Daiichi Sankyo bought a controlling stake in Ranbaxy, a generic-drugs company, in **2008** which it wrote down heavily as it ran into glitches with American regulators. And last year Abbott, an American health-care group, won an auction for Piramal's Indian drugs unit, which came with manufacturing facilities and a local sales force. But the price of **$3.7** billion, or over seven times the target's sales, suggests that the American bosses forgot to take their medication.

Abbott aside, though, the period of cross-border deals from and to India has gone beyond the euphoric stage, reflecting the wobble in India's economy, concerns about corruption and the deep troubles of the rich world. Both foreign firms keen on India and Indian firms keen to go abroad must show more discipline. This is not just about price-one executive working for a global investigation firm says Western buyers, worried about graft, are finding out more about whom they are doing business with in India. And with little in-house market intelligence about far-off countries, Indian firms need to be sure they aren't buying lemons. Giant trophy takeovers are likely to be pursued only by the biggest firms. For the others, a wave of smaller and probably more enriching deals and forays awaits. It takes longer to build champions this way, but the end results will be stronger.

One thing is fairly clear. The shadiest and worst bits of the economy, including natural resources and infrastructure, are notably bereft of outsiders. Where they have been allowed in, foreign firms' enthusiasm for India, and their open cheque books, have brought benefits. They have usually raised standards and cut prices through competition. But the power of competition can of course be unleashed in India in other ways, too. How about less government and more entrepreneurs?

The limits of frugality

Making things cheaper is not the same thing as making profits

THE MOST IMPORTANT event in Indian business in 2011 may have been an outburst on September 6th by Sunil Mittal, the boss of Bharti Airtel, the mobile-phone operator. India's telecoms industry is admired the world over for the innovative way in which it has slashed prices and put phones into the hands of even the very poorest. Today there are some 600m active subscribers in India, many of them in the countryside. But Mr Mittal said the extra cost of servicing rural customers, and their low usage levels, had made things unprofitable. Prices are now expected to go up across the industry, after two decades of decline. India's low-cost telecoms revolution has, it seems, reached its limit.

Indian firms have made much of their ability to serve the poor masses at the "bottom of the pyramid". Along with cheap phones, other celebrated examples include one-rupee sachets of shampoo and clever schemes to get around the lack of bank accounts. This reflects raw commercial instinct, but also serves an ideological purpose by showing that capitalism in India is not just for the middle classes. It is politic for Indian bosses to talk up their ability to invent things that all can afford.

Whether their firms profit as a result is less clear. Mobile phones are not the only field where the limits of frugality are being reached. Tata Motors' Nano, a $3,000 car, has been a flop so far. Some blame Tata's marketing, but other carmakers say they cannot achieve such a low price without compromising on quality, and that customers are wary. In air travel, insurance, consumer finance and satellite TV, companies have cut prices to build their customer bases over the past five years but could not reduce costs enough to compensate, and compromised on quality. As in telecoms, this is likely to lead to price rises and the exit of the weakest firms.

Today perhaps 17% of India's population has half of its spending power, according to the Asian Development Bank. Over time the growing urbanised middle class, who are getting richer fast, will become relatively more important for profits. Margins for these customers are likely to be higher because the cost of distributing products in cities is lower. The boss of one large consumer-goods firm says, in private, that today his company makes two-thirds of its money from the poor and lower middle classes, but adds it is "not enough" to focus on them since "the portion of upper middle class will become substantially more important". He is tilting his products accordingly. Consumer-goods firms are often keen to move away from cheap products, where Chinese rivals pose the greatest threat.

One proxy for the difference in profitability between the urban rich and the rural poor is the price paid for mobile-telecoms spectrum. In the 2010 auctions for 3G telecoms licences, operators bid ten times more for a slice of the airwaves in affluent Delhi, with 18m people, than in east Uttar Pradesh, with 120m people. Similarly, India is about to auction off FM radio spectrum and the competition is expected to be fiercest for the big cities, says N. Subramanian, the chief financial officer of Radio Mirchi, a big player today.

That is not to say that selling to the poor masses, and inventing ways to cut prices in order to appeal to them, is not vital. It is, both from a moral standpoint and because India's stability depends on it. But the big profits lie elsewhere.

Fonte: The Economist, London, v. 401, n. 8756, p. 11-16, 22 a 28 Oct. 2011.