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Close-up

A foray into overseas markets

The current M&A environment and its challenges (Part 1)

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M&A in India

Current challenges and possibilities

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India is in the running to be one of the top two most promising investment destinations for Japanese companies. As another wave of economic growth appears poised to lift the world's developing economies, India is a prime destination for Japanese companies that have already broken through in China and Southeast Asia. And yet the pace of entry into the Indian market has been slow.

While it has long been said that the keys to success in India are favorable relationships with local partners, thorough localization efforts, proper delegation of authority and quick decision-making systems, the fact is that many Japanese companies continue to struggle there. In the following, we consider ways for Japanese companies to succeed at M&A in the Indian market – where it can take up to five years to turn a profit.

The Indian market is hot ... but challenging

The Indian economy, described as being more than a decade behind that of China, is developing steadily and expected to surpass Japan in GDP terms by 2029. Domestic demand in a huge market boasting a population of 1.3 billion, combined with expectations for high growth and the realization of latent potential, have led to a gradual increase in the number and size of investments made by Japanese companies in India. Japanese companies that have already entered the Indian market are beginning to see results. But many others say that Japanese companies face significant difficulties when seeking to conduct M&As involving Indian companies.

The context for this statement is that, first and foremost, investing in Indian companies can constitute a long-term ordeal requiring significant patience and effort. In terms of negotiations, not only have pricing discussions necessitated fierce talks with target companies, but there have been instances in which target companies have requested retroactive changes to key contract documents such as memorandum of understanding and share purchase agreements. In terms of due diligence, information management at Indian companies tends to be poor, with desired information being hard to obtain and the process subject to delay. Indian authorities have failed on numerous occasions to grant timely approvals for various closing requirements related to licensing and so forth even after share purchase agreements had been signed.

Furthermore, even after investing so much time and despite expectations of being able to capitalize on domestic demand in the Indian market, companies have come to realize that the Indian market is much more cost-conscious than previously anticipated. Since the expected quality and pricing of products and services differ from region to region based on income levels and other characteristics, the investor faces difficulty in swiftly achieving profit plans envisaged at the onset of investments and also confronts impairment risks. The most worrisome topic for Japanese companies has been the question, “To whom can we entrust management of our Indian company?” Most companies end up leaving management in the hands of the existing Indian team, or appointing Japanese management personnel from within their own ranks. Few opt to look outside of their organizations to recruit executive talent.

However, these are common issues to be found in any developing market and are not necessarily unique to India. What, then, are the real difficulties facing Japanese companies investing in the Indian market?

Key issues that arise during Indian M&A

Valuation

- In accordance with the Foreign Exchange and Management Act, M&A deals involving the transfer of Indian corporate stock to a foreign corporation are subject to pricing guidelines set by the Reserve Bank of India (RBI) and require the RBI’s prior approval
- Foreign companies can only acquire shares from Indian companies at prices equivalent to or above the fair value (FV) set by specially licensed experts in India
- If a foreign company sells its business to an Indian resident, the business can only be transferred at a price equivalent to or lower than the applicable FV (resulting in the risk that put options may be impeded)

Due diligence

- Profit-inflation by target companies
  - Increased sales and reduced costs via related-party transactions with seller-side promoter affiliates
  - Unallocated and unamortized receivables despite un-collectibility
  - Unlawful underpayment of wages to factory workers and contract employees, unlawfully low rates of salary increment
- Insufficient registration of land ownership, inadequate maintenance of license and permits including Consent to Operate (CTO) various operations and procedures

Laws and financial regulations

- When acquiring part of a listed Indian company’s business via corporate carve-out, permission must be granted by Indian judicial authorities (time-consuming process)
- When a foreign company receives damages from an Indian company, prior approval by the RBI may be required under the Foreign Exchange and Management Act
- When a foreign company seeks to acquire a stake in an Indian company, it must provide proof of the trading value via an AD Category-I Bank (and payment must be conducted before the acquisition of shares is completed)

“Hot” top management, “cold” middle management

Few top management teams have given up on the Indian market—seeing as it’s the next major market for Japanese companies—and an increasing number of corporations are targeting India as part of their upcoming medium-term management plans. However, if you talk to middle management at any Japanese company targeting India as part of its next mid-term plan and ask them about their impressions of the Indian market, the responses are going to be polarized. No matter whom you ask, it’s likely that everyone apart from the individuals responsible for the India strategy in the first place will be less than enthusiastic. In fact, statistically, it appears that the rate of penetration into the Indian market has been even slower than the rate at which companies penetrated the Chinese market. So, what exactly is the reason for this difference in attitude between top and middle management?

Many Japanese businesspeople seem to hold the prejudiced opinion that Indian people are difficult to work with. From the perspective of businesspeople who are accustomed to Japanese culture and the capacity for individuals to somehow mutually grasp each other’s intentions, there is a sense that Indians are long-winded and audacious. For middle managers at Japanese companies who hold such impressions and who are ordered to participate in M&A projects in India, the pursuit of solutions that minimize investment risk often involves repeated and longform communications – an experience that can turn them off to the idea of engagement with Indian companies. For this reason, middle managers tend not to have such strong feelings and a sense of crisis as their upper management.

However, if a company invests in an Indian enterprise and simply entrusts management of the business to the existing management team, the company will struggle to set the ship right if results begin to sour and the cause of the poor performance is not identified in a timely manner. This being the case, from a long-term perspective it is necessary for companies to internally cultivate human resources who have been fully immersed in Indian projects and business. To accomplish this goal, top managers cannot simply leave this task to middle management. Rather, they must demonstrate that they are serious about the Indian business, and headquarters must implement measures to increase motivation by offering necessary support and feedback.

In fact, many young Japanese have quit their jobs at Japanese companies to pursue personal development in India that they felt was unobtainable in advanced, developed nations. If companies hope to penetrate the Indian market, top management might need to create jobs that offer the same rate and expectations for growth while establishing a work environment that can attract young talent by enticing them with the promise of realizing their Indian dream.

Keys to M&A success in India

It’s often said that corporate Japan’s successful penetration of the Chinese market has not been repeated in India; what isn’t said is that this is because companies are facing distinctly different environmental and historical factors than those found in China during the 2000s. Back then, Japanese companies sought to enter the Chinese market by setting up manufacturing bases from which they could export Japanese goods to developed countries. This was in line with the Chinese government’s policy of furthering economic development by becoming the “factory of the world,” and was easy to implement with government support. Today, however, most Japanese companies seeking to enter the Indian market are doing so with the intention of developing a new market altogether, and from the beginning have been attempting to capitalize on huge domestic demand.

Furthermore, it needs to be noted that India is a country that essentially exercises a policy of non-discrimination in regard to domestic and foreign investors. For example, although one of the main goals of the Indian government’s “Make in India” program is to recruit foreign investment, foreign companies should not assume that they will be given preferential treatment over Indian companies. In other words, whereas foreign companies can also benefit from “Make in India” incentives through the Indian companies in which they invest, they nevertheless must be prepared to compete with domestic companies when investing in key industries designated by the program.

An analysis of foreign companies said to be performing well in India reveals that they have the following characteristics: build healthy relationships with partner companies; promote quick decision-making; ensure thorough localization efforts; carry out large-scale advertising programs; demonstrate cultural understanding in their approach to managing local businesses; and take time to develop local human resources. In summary, many of these companies have focused on achieving success through localization. In addition, these companies typically have upper management teams that exhibit a strong commitment to efforts in India.

M&A is an effective tool when localization efforts require the help of local Indian management personnel. However, the time a company can buy itself through M&A is limited to the time it would have taken to set up an overseas production base and sales network; an M&A can't buy it the time it will need to invest in growing its profitability. In an Indian market comprising a wide variety of territories, anticipating the synergistic effects of introducing Japanese best practices and post-acquisition cross-selling can be difficult, so acquisitions must be tailored to local specifications and companies may need to conduct post-acquisition investment into management resources. Ultimately, the acquiring company has no alternative but to utilize time and management resources gained through M&A, as well as additional post-acquisition support, to set its sights on becoming number one in the local market.

Japanese companies who want to succeed in M&A in the Indian market should consider the following measures:

1 Clarify "definition of success"

Upper management teams must clarify their "definition of success" early on and base discussions with Indian target companies upon that paradigm. They must eliminate all traces of ambiguity, firmly coordinate policies to produce foundational documents, and avoid a scenario in which both parties are operating under different visions. Upper management must build trusting relationships alongside Indian management teams for the realization of mid- to long-term goals.

2 Thorough risk assessment

Companies must thoroughly and pre-emptively investigate potential risk factors, including those associated with management teams at Indian target companies and business partners. India is a surprisingly gossip-oriented society, making it possible to conduct effective reputational research. The past is littered with case after case of investors choosing to ignore the facts and push ahead; the investments have often resulted in unsuccessful outcomes and exit. Needless to say, the cost of research is lower than the cost of exit. In many cases, detected risks can be addressed through consultations with the management teams at target Indian companies. Upper management should acknowledge that they will not be able to remove the risk and should focus instead on "controlling the risk."

3 Maintenance of local support system by main office

Following an M&A, the head office should be responsible for creating the systems that will be used to achieve the business management and compliance performances. To prevent Japanese expats who have been dispatched to India from struggling in isolation, the head office should implement a support system that provides local Indian experts to assist them. Such a system will reduce the psychological burden on dispatched expats and allow them to concentrate on management issues.

As stated above, companies have much to consider when pursuing successful M&A in the Indian market. As one objective of M&A involving Indian companies, firms should also have a view for incorporating competent Indian executives into their own company and developing them as bridgeheads for further expansion into the global market – i.e. from India to Africa and beyond. An aging population, low birth rate and work style reforms are leading to drastic changes in Japan's working population and work environment. In contrast, India is overflowing with human resources who can play an active part in today's global economy, and a company has every reason to use this to their advantage. Making the most of this opportunity, Japanese companies should consider bringing promising Indian personnel to Japanese headquarters for training while fostering a sense of belonging among staff at Indian investee companies.

It is our sincere hope that Japanese companies will make use of M&A involving Indian companies to resolve the issues that they face, and that this in turn will lead to a further deepening and development of their efforts to globalize.

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