GM Corporate Solutions

Financial & Strategic Advisors

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India: Economy and M&A trends

Economic Overview

There have been signals of an economic slowdown in India in the past few months. As per Government data, India's GDP growth rate for Q1 of FY 2019-20 declined to 5% (at constant prices) which is the slowest in the last 6 years.

This growth recession is particularly visible in the auto, manufacturing, and real estate sectors. The rising number of NPAs, the liquidity crisis in Banks & NBFCs, leading to cash crunch situation and sluggish consumer demand point to the overall slowdown of the economy. What needs to be observed is how long it is going to last and the measures the Government will take to overcome this situation.

The decline in private consumption in urban areas is due to reduced income growth and some bit may be due to an overall low sentiment about de-growth stories. Rural areas are affected due to reduced food prices and lower offtake and of course, the consumption side is moving slow due to lesser liquidity.

The real estate sector is still finding its footing since the demonetization that occurred in Nov 2016.

This decline in the growth rate is also affected by the reduction in India's exports, caused due to contraction in the world trade, which in turn may be indirectly caused by the ongoing US-China trade war.

As per the RBI, the Indian economy is undergoing a cyclical slowdown rather than a deep structural one, further adding that issues related to land, labor, and marketing need to be addressed.

This year saw the re-election of the Modi government, which in its earlier mandate had pursued macroeconomic stability and a business-friendly regulatory framework with bold, decisive moves. The Government has set an ambitious target of achieving the USD 5 trillion GDP mark in five years through an investment-led growth.

M&A Trends thus far

This year, so far, has been tepid in terms of deal activity. The aggregate deal value for the January to July period has been USD 22.1 bn, compared to the mammoth USD 73.6 bn last year for the same period.

Sector-wise, manufacturing, energy, start-ups, pharmaceuticals, infrastructure, IT, banking, and e-commerce have comprised about 90% of the total deals this year.

Cross-border M&As have also witnessed a decline in both inbound as well as outbound transactions, vis-à-vis last year. The US was the top investor, accounting for about 26% of all inbound deals, followed by Japan at 12% and Japan at 10%. For outbound investments, the US again retained the top spot with about 40% acquisitions by Indian companies happening over there.

While the seed funding has grown at about 23% from 2015 to 2018, there has been a decline in terms of volume. In 2017, 546 seed-stage start-ups were funded, which dwindled to 329 in 2018. In the first half of 2019, only 139 seed-stage start-ups were funded, which is quite low compared to the half-yearly average of 2019 (from 2014-2018).

On the other hand, there has been an upswing in growth-stage acquisition with 19 acquisitions already in the first half of 2019, compared to 13 for the entire 2018, and 17 for the entire 2017.

Policy Liberalisations Continue

The government has been taking continuous steps towards liberalization and measures to improve growth & attract foreign investors. Some of the recent steps are as follows:

Further Liberalisations in FDI Policy

The Union Cabinet on August 28 approved certain proposals liberalizing FDI policy in some of the important sectors, though these approvals are yet to be implemented via amendments to the FEMA law.

- **Single Brand Retail Trade (SBRT)**: Presently, 100% FDI is allowed under the automatic route along with compliance of certain conditions. Some of these conditions are being dispensed with:
  - An SBRT entity can commence online retail sales prior to opening a brick & mortar store, provided that it would open the brick & mortar store within 2 years from the date of the start of online retail sales.

  - Earlier, it was mandatory to procure 30% of the value of goods sold in India, locally. Now, all the procurements made from India would be counted as local sourcing, regardless of where such goods are sold.
  - Earlier, the incremental sourcing for global operations done through group companies was also counted towards local sourcing requirements. This has now been expanded to include sourcing from a third party under a legally enforceable agreement.
- **Coal Mining**: As per extant norms, 100% FDI under automatic route is permitted for coal & ignite mining for captive consumption by certain industries. 100% FDI under automatic route is also permitted for setting up coal processing plants provided that they shall not do coal mining and shall only sell washed/sized coal to the parties supplying raw coal.

  Now, the Government has approved the proposal to permit 100% FDI under automatic route for sale of coal, for mining activities, including associated processing infrastructure. This means that foreign mining companies can now own coal mines and carry out processing & sale, including exports.

- **Contract Manufacturing**: No restrictions exist for FDI in any manufacturing activity under the present legal framework. The Cabinet has further clarified that 100% FDI under the automatic route also applies to "Contract Manufacturing".
- **Digital Media**: To achieve parity between print and digital media, the Cabinet has decided to mandate a limit of 26% FDI under the government approval route for digital media. The move is expected to provide a level playing field for Indian news publishers and news aggregators.

Angel Tax – No More

Angel tax was introduced in 2012 to tax domestic capital invested into private Indian entities as income if the investment was made above the fair market value. This tax has had an adverse impact on the startup landscape.

It is pertinent to note that about 10% of all the funds raised by Indian startups have come from Indian sources. Of this, the majority has been seed or angel funding, which have been hit by Angel Tax.

As a corrective measure, in Feb this year, the Government exempted Indian startups from angel tax for fundraised up to INR 250 million. However, this exemption did not cover startups who had already been served with notices by the Income Tax department.

The Finance Minister on August 23 announced that the Angel Tax is inapplicable to startups registered with DPIIT and assured that no coercive action would be taken to recover tax demands. This brought much-needed clarity and relief to the ecosystem. The CBDT has also constituted a dedicated startup cell to address the grievances of startups, which can be filed online as well.

There are certain critical aspects that still remain to be resolved to provide a further fillip to the startups and their investors. Examples are the tax on long term capital gains, exemption from negative list of investments, high penalty on transactions where share premium is involved, and protection from investigation of the Income-tax department officials.

Policy Liberalisations Continue

Faster approval by Competition Commission of India

The Competition Commission of India (CCI) has introduced a green channel approval for parties with no horizontal, vertical, or complementary overlaps. In a horizontal overlap, the parties to a deal are competitors in the same market and in vertical overlap, the parties are involved in different stages of the supply chain for a product or service.

To avail the green channel, a notifying party is just required to make the requisite declaration to the competition regulator. Upon filing the same and its acknowledgment by the CCI, the combination would be deemed to have been approved by the regulator.

Thus, now there are three approval routes: the green channel route, Form 1 filings for transactions above the threshold and not meeting the green channel route, and Form 2 filings for more complex transactions. Private equity firms, foreigners or Indian companies investing in a new sector are going to benefit immensely from this.

Relaxations in External Commercial Borrowings Policy

RBI has relaxed the end-use norms of funds raised via ECBs, allowing the ECBs with a minimum average maturity period of 10 years to be used for working capital requirements and general corporate purposes.

Corporates and NBFCs would also be allowed to use proceeds from ECBs with a minimum average maturity period of 7 years for repayment of rupee loans raised domestically for capital expenditure. The minimum average maturity would have to be 10 years for repayment of rupee loans raised domestically for purposes other than capital expenditure and for on-lending by NBFCs for the same.

The RBI would also permit corporates to use ECB for repayment of rupee loans raised domestically for capital expenditure in the manufacturing and infrastructure sector and classified as special mention accounts or non-performing assets, under any one-time settlement arrangement with lenders.

The above relaxations would allow greater access of funds for corporates and NBFCs and help in reviving growth in sectors which are presently facing challenges due to lack of adequate capital.

Relaxation for Foreign Portfolio Investors (FPIs)

With the announcement of surcharge on capital gains in the Union Budget, Foreign Portfolio Investors had withdrawn over USD 3 billion from the domestic markets. The surcharge was rolled back by the Finance Minister on August 23.

In another move, SEBI has eased the process of FPI registration by doing away with the broad-based eligibility criteria for FPIs, under which at least 20 investors were required to establish a fund. Also, central banks that are not members of the Bank for International Settlements (BIS) would also be allowed to register as FPIs.

SEBI has also simplified the KYC requirements and permitted the FPIs to carry out off-market transfer of securities to any domestic or foreign investor even if the stock of such a company is unlisted, suspended or illiquid.

Under the new framework, FPIs would be classified into two categories instead of three. Till now, SEBI classified FPIs into three categories, with the easiest set of compliance norms for Category-I FPIs and the strictest for Category-III FPIs. The classification of an FPI depends on the way the offshore entity is regulated in its home market or the number of investors in the fund. The most well-regulated FPIs fall into Category-I. SEBI has now removed the concept of Category-III FPIs.

The requirements for issuance and subscription of offshore derivative instruments (ODIs) have also been rationalized.

Presently, the investment cap for an FPI is 10% for an individual entity and 24% for all FPIs. In the Union Budget 2019, it was proposed to increase the statutory limit for FPI investment in a company from 24% to sectoral foreign investment limit with an option with the concerned corporate to limit it to a lower threshold. It was also proposed to permit FPIs to subscribe to listed debt securities issued by Business Trusts. It remains to be seen when these proposals would be accepted and implemented.

It has also been proposed to merge the portfolio investment scheme for NRIs with foreign portfolio investment scheme thus paving the way for NRIs to invest more than 10% of the paid-up capital of a company, where there is lower investment by foreigners in that company.

Global Headwinds and Way Forward

Trade Wars and Brexit

Global FDIs slid by 13% in 2018 to USD 1.3 trillion vis-à-vis USD 1.5 trillion in the previous year.

The US has the largest trade deficit in the world, at USD 672 billion in 2018. In early 2018, the US President initiated global tariff on steel, a tariff on European autos, and tariffs on Chinese imports. This has resulted in the imposition of tariffs on imports from the US as well. The US is presently engaged in trade war with China, the EU, Mexico, and Canada. Due to this, the affected countries have been signing new trade agreements with other countries and left the US out of the loop.

The negotiations between the US and China are ongoing. However, if the talks fail, there would be a major realignment in exports with a search for new destinations for surplus production.

In the European Union, the new UK Prime Minister has promised to execute Brexit by 31 October with or without a deal. Brexit would take the UK off the main stage of the financial world.

Brexit impact on the UK and the EU would be felt through decreased intra-regional trade, decreased FDI inflows & outflows, change in industrial policy, tightened immigration, trade disputes, decreased international influence, and decreased budget. The UK would become unattractive as a gateway to Europe, as a base for corporate headquarters, and as a location for investment from Europe.

For India, Brexit would mean a renegotiation of trade terms with the UK and the EU. On account of an expected depreciation of the British Pound, Indian investors in the UK may get more favorable investment opportunities.

The increase in protectionist policies worldwide have created uncertainties slowing down capital investments.

Opportunities in India

As per the UNCTAD's World Investment Report 2019, India's FDI inflows in FY 2018-19 remained strong at USD 64.4 billion, marking a 6% growth over the year prior. Further, India is likely to increase its exports by as much as $11 billion in the long term due to the fall out between the US and China.

Further, there could be increased investment and capital flow between India and the US and India and China, as China and the US seek to disentangle themselves. Some of it is already visible. Chinese companies have in recent times made a beeline to invest in India especially in the area of telecommunications. India is one of the biggest markets for Chinese mobile brands like Xiaomi, Vivo, Oppo, Lenovo and Oneplus.

The Indian Government too has continued to introduce more reforms to revive the muted growth. Recently, the Union Commerce Ministry identified over 200 products where India's exports could be increased to the US, replacing Chinese goods. Further, it also identified about 150 items where exports to China could rise.

The reforms that have been introduced so far indicate that the government is keen on stimulating demand and improving ease of doing business on various fronts. RBI's transfer of INR 1.76 trillion reserves to the government, which amounts to 0.75% of the GDP, can help jump-start planned government spending.

The surplus in agriculture along with soft prices globally would keep food inflation low. The changing dynamics of global oil markets are likely to keep oil prices, and India's import bill, manageable. The bankruptcy proceedings under the IBC are likely to make fuller recapitalization of banks possible. Increased thrust on robust regulation, corporate governance, simplified labor laws (which the government is set to bring) would further improve the ease of doing business. The upcoming festive season could see demand pick up.

From a global standpoint, India is still one of the fastest-growing markets and the long-term outlook continues to remain bullish with many seeing the ongoing global situation as an opportunity for India to exploit.

Glossary

Abbreviation	Description
CCI	Competition Commission of India
DPIIT	Department for Promotion of Industry and Internal Trade
ECB	External Commercial Borrowings
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act, 1999
FPI	Foreign Portfolio Investors
GDP	Gross Domestic Product
IBC	Insolvency and Bankruptcy Code
KYC	Know Your Customer

Abbreviation	Description
NBFC	Non-Banking Financial Company
NPA	Non-Performing Assets
NRI	Non-resident Indian
RBI	Reserve Bank of India
SEBI	Securities and Exchange Board of India
SBRT	Single Brand Retail Trading
USD	United States Dollar

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