The Deal
Custom Media Division
Issue Date: October 30, 2006

Eyes on America

Even as the private equity market opens up in India, U.S. private equity firms and bankers would do well to pay attention to the growing number of Indian acquisitions of U.S. companies.

Given the accelerating rate at which international private equity firms and strategic investors are putting money into Indian companies, the opposite trend that of Indian companies acquiring companies abroad, has gone largely unnoticed. Yet it shouldn't be. Consider Tata Steel's recently announced buyout offer of $8.1 billion for the Anglo-Dutch steelmaker Corus, or Tata's other moves in the U.S., where the Indian giant snapped up Boston's Ritz-Carlton Hotel, energy drink maker Glaceau and Eight O Clock Coffee. It's a trend private equity firms and bankers looking to expand their options when considering the sale of a portfolio company should pay attention to.

It's a trend that's also revving up rapidly. In 2002, the value of all the deals involving Indian acquisitions of overseas companies totaled just $97 million, while in the first nine months of 2006 alone, that figure has grown to $1.9 billion. Much of that activity has involved acquisitions of European companies, but the share of these cross-border deals involving U.S. businesses is growing quickly.

Up until last year, most of these acquisitions were primarily in the technology, auto-components and pharmaceutical sectors, but that's changing as Indian companies look to sectors such as home textile, apparel and consumer goods retail. Case in point: Last February, India's Gujarat Heavy Chemicals Ltd. (GHCL) acquired 90 percent of Danville, Va.-based Dan River, a $250 million manufacturer of home textiles, for $93 million—$17 million in cash plus the assumption of $76 million in debt. The deal was driven by GHCL's desire to diversify beyond its bulk chemicals business. The company plans to shutter several of Dan River's U.S. production facilities and outsource most of its production to factories in India, Pakistan and China. Much like the trend toward information technology and business process outsourcing, the GHCL's plan will allow it to cut costs while giving it access to U.S. markets.

Such deals are very much at the heart of India's move to stretch beyond its borders in an increasingly globalizing world. With the rapid rise of its middle-class, India's domestic market is growing rapidly, but staying home is not necessarily the best model for growth for a lot of Indian companies.

Meanwhile, recent regulatory changes in India have boosted the ambitions of many Indian multinationals. In January 2005, the government raised the cap on foreign investment by Indian companies from $100 million to the level of the company's net worth. And that same month, the World Trade Organization abolished onerous quotas on the importation of textiles into developed countries, allowing India to expand production and exports of textiles and apparel to these markets.

Says Anil Kumar, managing partner of Virtus Global Partners, a cross-border mergers and acquisitions advisory firm: "You have to look beyond the domestic market, because you can increase revenue, and through cost-cutting improve margins at the same time. So a lot of these deals involve both a revenue play and a margin play."

This cross-border M&A activity isn't limited to basic manufacturing. Manufacturers and service providers in a variety of sectors—including information technology, pharmaceuticals, auto components and apparel as well as textiles—are finding the U.S. market attractive. Take jewelry: the vast majority of diamonds sold around the world are cut and polished by Indian companies, yet those companies have typically been forced to sell their wares to global distributors. So one of the few sources of growth for Indian firms has been to move abroad and try to cut out the many middlemen in the diamond business.

To that end, Kumar's firm is currently advising an Indian jewelry manufacturer as it looks to purchase as many as 100 retail outlets in the U.S. By doing so, the company can use those stores as a front-end distribution point for its diamonds, which would continue to be sourced, cut, polished and set back in India. The hope is to boost revenues through the retail sale of the jewelry while improving margins by avoiding the middleman and sourcing in India.

Front-end distribution is a common theme in many of these deals. Following its purchase of Dan River, for instance, GHCL paid $40 million for Rosebys, a U.K. home furnishing retail chain; and this month, S. Kumars outbid several other companies and private equity firms to buy American Pacific, a U.S. home furnishing maker and distributor, for around $90 million.

The growing number of these sorts of deals, Kumar notes, is why U.S. private equity firms and bankers should think about India as an option as part of their exit strategy for certain kinds of companies. In his experience, he notes, "Indian companies bring higher synergies to a transaction. That synergy occurs because the U.S. is typically new territory for a lot of Indian buyers, and that means new customers for Indian companies, with none of the competitive overlap that typically occurs when U.S. buyers acquire U.S. companies. And the significant cost-cutting opportunities especially if an Indian manufacturer buy a U.S.-based front-end retail operation, and then source product back in India, provides another impetus for Indian buyers to pay up."

In this sense, says Enrique Arzac, a professor of finance and economics at Columbia University's Graduate School of Business, these companies are only doing what American and European

companies have been doing for more than a century. "Indian companies want to get close to the consumer, and the U.S. is the largest and most sophisticated market in the world. Companies cannot have a global strategy without a presence in the U.S."

For similar reasons, India's apparel sector, while it hasn't completed any major deals in the U.S., is looking hard at the market, with several deals in the pipeline, either to acquire distribution or retail front-ends. "Such deals will improve margins by sourcing product directly from India," says Kumar, "But just as important in the fashion industry, they can help decrease the lead time between the design and manufacturing of the clothing and its appearance in U.S. stores."

Typically in these deals, the Indian companies have paid for their U.S. acquisitions in cash, mainly because most Indian companies are still owned and managed by the families who founded them, and they are often reluctant to bring other parties into the shareholding structure. Moreover, regulatory issues make it difficult to issue stock to foreigners for considerations other than cash, while the capital markets in India may require onerous lock-in periods when new stock is issued.

Such rules are becoming less and less common as India's economy matures and its global ambitions grow. Still, Kumar advises caution when doing business with Indian companies. "Companies in certain industries," he notes, "including pharmaceuticals and technology, are more modern in the way they are managed, and many of their managers have actually worked in the U.S., then gone back to India. They're pretty well-versed in the U.S. environment. But much of the rest of India is slowly adapting to new changes." This is particularly true of the many family-controlled companies there, and the right advisers, who may have dealt with a particular company in the past, and who have experience with that family group, are particularly important in bringing off a successful deal, says Kumar.

Columbia's Arzac notes that these considerations are no different for an Indian company acquiring a U.S. company than for a U.S. company acquiring an Indian company. "Know the market, know the culture, know the quality of the management the acquirer will need to relay on once it takes over. Understanding the culture, regulations, legal framework and tax consequences of the target country are fundamental considerations. These are the areas where a strong financial adviser who knows the terrain and will help the potential acquirer to avoid many of the pitfalls associated with cross-border acquisitions can be most helpful."

Still, those pitfalls are becoming less serious as Indian companies gain more experience in making foreign acquisitions. Kumar is proud of India's accomplishments in liberalizing regulation, modernizing the business environment and boosting the country's growth over the past decade. "We've reached a self-sustaining pace now. The basic fundamentals are there. And both domestic and cross-border M&A will keep increasing at a strong pace."