Asia Watch:

Foreign Equity Investment in Indian Companies

By David Laverty, Partner, InternationalCounsel

Wal-Mart's recent Indian joint venture with Bharti Enterprises focused media attention on some of the remaining foreign investment restrictions in India. Though India is opening foreign investment in retailing only in incremental steps, the restriction of some sectors in a target country should not cause investors to assume that their own sectors or investment structures would also be restricted. Despite some remaining restrictions, India is relatively open to foreign investors, and private equity and venture capital funds are offered even more favorable treatment not available to other investors.

REGIONAL WATCHES

Each Regional Watch is authored by an ACG Chicago member with experience in his or her respective region. The author monitors developments within the region to identify significant business trends and highlight the implications.

Background—India's Foreign Retailing Restrictions

Contrary to its usual market entry model, Wal-Mart will hold no equity in its India retail stores and will receive only a royalty from Bharti, the 100% owner, through a franchise structure. Wal-Mart and Bharti will be equal equity partners in a joint venture for some of the back-end functions, including the Indian wholesaling function.

Foreign companies such as Wal-Mart cannot own an equity interest in Indian retailing operations apart from up to a 51% interest in "single-brand" retailing, meant to include companies such as Gap and Nike that sell only products carrying a single brand name. Even this limited recent opening (mid-2006) was controversial, and Wal-Mart's entry is characterized by some in India as an unfair back-door attempt by a "multi-brand" powerhouse to skirt existing restrictions meant to protect local retailers.

Retailing in many countries has been one of the last sectors to open to foreign investors for a few key reasons: a large and important political base of both "mom and pop" and larger local stores seeking to protect their turf coupled with a belief among some countries that investment in retailing and distribution does not offer as much of an economic benefit as investment in high technology and other favored sectors. China offers one example of a slow and incremental opening of retailing: though it had already begun in the early 1990s to permit foreign equity in "multi-brand" and other retailing, China first permitted foreign-invested stores only in single cities before offering the first "national" retail license to a US retailer, and then only if through a minority interest with a pre-selected Chinese partner.

Outside of Retailing, 100% Foreign Equity is Broadly Permitted

Outside of the retail sector, a broad range of industry sectors in India is open to 100% foreign ownership, including most information technology, business process services and software production sectors that have fueled the "outsourcing" boom, as well as many manufacturing, wholesaling and biotech sectors. An "automatic approval" process covers many such sectors. For foreign investors, only a relatively limited range of sectors (including courier services, general periodical publishing and tea-related activities) require formal approval by India's Foreign Investment Promotion Board (FIPB) and only a handful of sectors are outright prohibited (ranging from gambling to the kind of "multi-brand" retailing pursued by Wal-Mart).

Fewer Restrictions Apply to Those Investing Through a Foreign Fund

Even for open sectors, other restrictions may apply to foreign investors, such as a required FIPB approval for the purchase of shares from existing shareholders (but not for the purchase of newly-issued shares). However, India imposes fewer restrictions on investments through venture capital, private equity and other foreign funds registered with the Security and Exchange Board of India (SEBI). For example:

- Many industry-specific equity caps and other restrictions that apply to foreign investors are not imposed on a registered foreign fund that invests in Indian private companies—though the fund cannot invest in activities prohibited to foreign investors, such as "multi-brand" retailing; and
- A fund can purchase shares in an investment or M&A transaction, or sell shares in an exit from a private Indian company, at a negotiated price and is not forced to comply with net asset value restrictions that would normally apply to other foreign investors

Also eliminated for a registered fund is a 1-year post-IPO lock-up for pre-IPO shareholders, as well as capital gains and withholding tax on income received by the fund from invested Indian companies. However, income distributed by the fund to investors is taxable—hence the popularity of investing through Mauritius, Singapore and other favorable tax treaty jurisdictions.

Conclusion and Practical Implications for US Investors in India

As a private equity investor seeking to add portfolio company value through cross-border expansion, or as the chief executive officer of or advisor to a growing mid-market company, all roads do not lead to China and do not be discouraged by talk of foreign investment restrictions in countries such as India. As with investments in other countries, the truth in India is more complex - equity limitations and other restrictions that apply to a sector such as retailing are more the exception than the rule, and many industry sectors are open to 100% foreign equity ownership. An even closer look at different types of investment structures can reveal other advantages—in India's case, opportunities available to a foreign investor may look even better if structured through a foreign fund investing in Indian companies.

* * *

The author, David Laverty, a partner with the law firm of InternationalCounsel, wishes to thank the law firm of Rajinder Narain & Co, New Delhi, for its verification of aspects of this article. Like a Fortune 100 company's in-house international legal team, InternationalCounsel's international contracts and cross-border investment lawyers assist mid-market and larger companies in Asia, Europe and elswhere. Apart from his own experience with India, David's China retailing comments are based on his experience with a US retailer's early 1990s China market entry. For more information on this topic please contact the author: laverty@internationalcounsel.com, 312-575-0601.