# Economic Watch
India

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Economic Analysis

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## India's overseas direct investments – Notable growth, but yet to achieve scale

- **External orientation of Indian companies has increased remarkably over the past decade.** Since 2003, India's stock of overseas direct investments (ODI) has jumped 35 fold to USD 241 bn in 2013. Despite a low per capita income level, the rising tide of foreign investments by Indian companies over such a short span of time is noteworthy.
- **The post crisis period after 2008, shaped by a challenging macro environment in India, has seen slower average annual growth in ODI flows** compared to the 2004-08 period - from 82% y/y during 2004-08 to 21% y/y over the past five years. The fiscal year ending March 2014 (FY14) saw a sharp pick up in ODI flows to USD 38 bn, up 43% y/y, following two successive years of moderation.
- **Despite exceptional growth, India is a small source of global investments.** India's share in world ODI stock is low at just 0.5%. Meanwhile, as a share of GDP, India's ODI stock matches that of China (at 6%) but lags behind Mexico (12%) and Chile (37%).
- **Drivers of ODI flows from India are both domestic and international.** These include market seeking factors such as limits to market size, government policy issues, and increased competition and resource seeking factors, which have gained prominence given India's widening energy deficit. Importantly, higher cost of doing business in India due to governance and administrative issues and poor infrastructure has pushed Indian companies to venture abroad for setting up manufacturing facilities.
- **We reclassify the list of host economies for India's ODI flows to include offshore financial centers based on their proximity to the region.** Our study suggests that Europe has received the largest chunk of investments from India since 2008 followed by Asia, Africa and North America. Singapore, Mauritius and Netherlands are India's favorite offshore centers for mobilizing financial resources. Excluding offshore centers, the US and UK top the list of India's ODI destinations.
- **Manufacturing sector has received the bulk of ODI flows from India since 2008, but its share has declined overtime.** Resource seeking overseas investments from India has increased in recent years, particularly in the energy and mining space. This is driven by India's widening energy deficit. According to the BP Energy Outlook 2035, India's primary energy deficit has more than doubled from 82 million tonnes of oil equivalent (Mtoe) in 2000 to 219 Mtoe in 2012 and is expected to widen further to 578 Mtoe by 2035.
- **India's strong and stable government can foster two-way capital flows by boosting export performance.** Apart from fostering domestic export orientation, the government should focus on cementing existing bilateral and regional trade and investment agreements as well as ink new ones. This would spur Indian companies to achieve global scale and benefit from reciprocal market access in other countries.

# India's overseas direct investments – Remarkable growth but still a small source of world investments

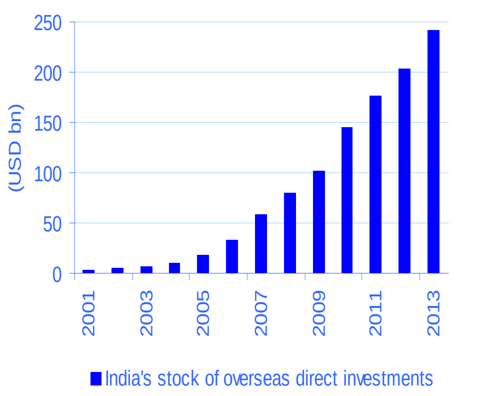
External orientation of Indian companies has increased remarkably over the past decade. Since 2003, India's stock of overseas direct investments (ODI) has jumped 35 fold to USD 241 bn in 2013 (See Chart-1). The bulk of this investment, nearly 70%, has taken place in the past five years. Since 2009, Indian companies have invested USD 161 bn overseas as compared to USD 73 bn during 2004-08. For a highly populated developing economy with low per capita income level[1], the rising tide of foreign investments by Indian companies over such a short span of time is noteworthy, especially when compared to recent trends in ODI flows across most other developing economies in Asia as well as Latin America (See Chart-2).

## Pace of overseas investments from India has moderated post the 2009 credit crisis

Annual growth in ODI flows from India has been choppy with a clear trend difficult to discern. The past fiscal year ending March 2014 (FY14) saw a sharp pick up in ODI flows to USD 38 bn, up 43% y/y, following two successive years of contraction (See Chart-3). Annual ODI flows had hit a record high of USD 44 bn in FY10.

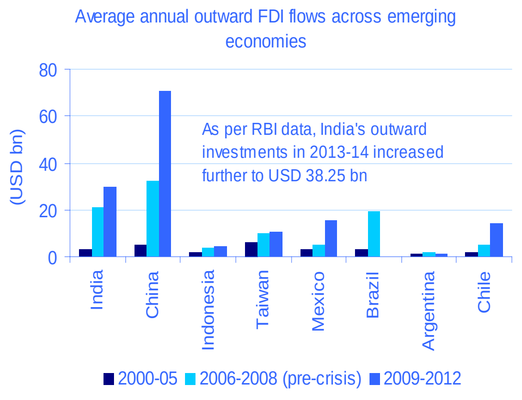
However, from a broader perspective, we find that the post crisis period after 2008 has seen slower average annual growth in ODI flows from India compared to the 2004-08 period (82% y/y during 2004-08 to 21% over the past five years). This can be attributed partly to the low base starting 2004, but in large part to the constraints faced by Indian companies in funding larger overseas acquisitions amid high financial market uncertainty and a difficult domestic macro environment. India's GDP growth decelerated from 8.6% y/y in FY10 to sub 5% y/y levels in FY14, which combined with high inflation, tight liquidity conditions and a volatile rupee hurt business sentiment and dampened corporate profitability.

Chart 1
**India's stock of overseas direct investment (ODI) has jumped 35 fold over the past decade**




Source: BBVA Research, RBI, UNCTAD

Chart 2
**Average annual ODI flows from India have surpassed several emerging economies over recent years**




Source: BBVA Research, RBI

[1] As per the IMF, India's per capita income stood at USD 1504 in 2013 compared to USD 6747 for China. India is ranked 140th in the world in terms of per capita GDP.

Underscoring this trend, Grant Thornton, a global mergers and acquisition (M&A) activity tracker, notes that the number of outbound M&A deals by Indian companies fell sharply in calendar year 2013 to just 82 from 122 and 146 in the previous two years. The muted M&A activity was offset by high value Greenfield overseas investments, particularly across energy, mining and business services sector.

### Despite exceptional growth, India remains a small source of global investments

In terms of scale, India remains a small source of global investments with 0.5% share in world ODI stock (See Chart-4). This compared with 2.2% for China and 1.0% for Brazil. As per UNCTAD data, India's stock of overseas investment at USD 118 bn in 2012 supersedes that of Indonesia (USD 12 bn) and Chile (USD 97 bn) but lags far behind China (USD 509 bn) and Brazil (USD 233 bn). Furthermore, India's overseas investments in per-capita terms are discernibly low at USD 94, compared to USD 376 for China, USD 1174 for Brazil, USD 1185 for Mexico and USD 5575 for Chile.  Meanwhile, as a share of GDP, India's ODI stock looks reasonable, matching that of China (at 6%) but still lags behind Brazil (10%), Mexico (12%) and Chile (37%).

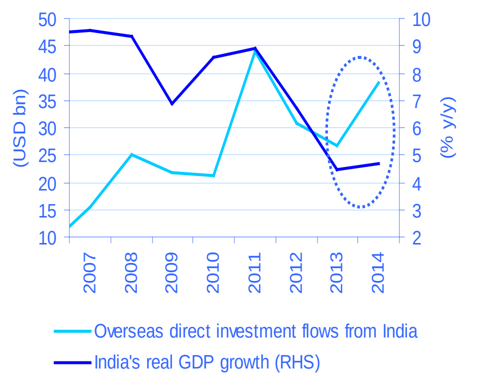
## What is driving Indian companies abroad?

Factors driving outward direct investments from India over the past decade are both domestic and international; as also industry specific. The main drivers of Indian outward FDI can be grouped into four broad categories, namely;

A) Market seeking: Limits to growth in Indian markets due to – 1) constraints on market size as such due to low per capita income levels in India or low technology penetration, 2) government policy issues such as poor domestic infrastructure, 3) increased competition at home as seen in case of Indian telecom space, 4) protection of export markets and 5) widening the market base as seen across Indian manufacturing and financial firms.

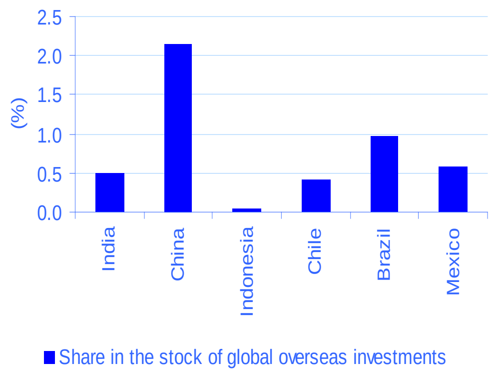
B) Resource seeking: Acquisition of key resources, especially natural and technological, which would help safeguard future supplies of raw materials, enhance productive capacity and augment backward integration. These deals are largely concentrated in the energy space.

Chart 3
**Notwithstanding domestic macro challenges, ODI flows from India picked up sharply last fiscal year**




*Fiscal year ending March, Source: BBVA Research, RBI

Chart 4
**In terms of scale, India remains a small source of global investments, lagging far behind China**




Source: BBVA Research, UNCTAD

C) Asset seeking: Investments to safe-guard or expand firm specific advantages across R&D, and trademarks as observed in case of Indian pharmaceutical and automobile companies.

D) Efficiency seeking: Investments by Indian companies across emerging economies or near client locations to seek higher efficiencies by getting access to cheaper labour and seek technological advantage – seen among Indian IT and financial services companies

### India's sufficient FX reserves have provided a crucial buffer for ODI flows:

Private firms (mostly publicly listed) lead India's outward FDI flows and showcase strong technical, marketing and managerial capabilities, which transfer well across foreign markets. Importantly, gradual liberalization of India's capital controls, particularly after year 2000, has encouraged two way flows in India. Being a current account deficit economy, India's sufficient FX reserves have served as a buffer to capital outflows. India's FX reserves have increased significantly over the past decade, from USD 40 bn in the year 2000 to around USD 310bn today.

### Poor domestic infrastructure and administrative bottlenecks have been a key push factors for India's overseas direct investments

Domestic business in India remains constrained by an inefficient operative environment, governance and taxation issues and delays in investment reforms. These bottlenecks hinder rapid infrastructure development and natural resource exploration and raises logistical hurdles, in turn translating into higher cost of doing business in India. These issues have stymied manufacturing activity in India with the sectors share in GDP at a low 16% and in turn pushed several domestic manufacturing firms to invest abroad to tap resources or set up production facilities.

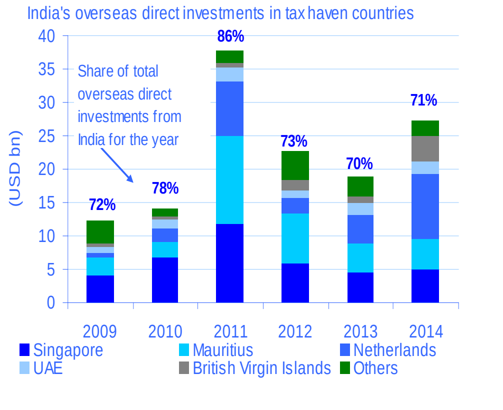
## Tracking host economies for India's ODI – Bulk goes to offshore financial centers followed by the US & UK

Around 75% of India's annual ODI flows are routed through offshore financial centers (OFC) or tax haven countries (See Chart-5). As such, Singapore, Mauritius and Netherlands are India's favorite offshore centers for mobilizing financial resources. Key among other tax havens includes the UAE, British Virgin Islands, Cyprus, Switzerland and Cayman Islands.

Singapore tops as India's most favored destination for overseas investments. Between July 2007 to March 2014 (given the data available from RBI), the Asian hub has attracted USD 39 bn in investments from Indian companies, which is 21% of the total ODI flows from India during the period (See Chart-9). Other tax haven economies such as Mauritius (USD 36 bn) and the Netherlands (USD 29 bn) come a close second and third respectively. The United States (USD 13 bn or 7% share) is fourth in the list followed by the UAE, British Virgin Islands and the United Kingdom (USD 6.7 bn or 3.6% share).

Country-wise, excluding tax haven economies, the US is India's favorite investment destination followed by the UK (See Chart-6). India's investments in the US are mainly concentrated in the financial, business and software services (40%) and manufacturing sector (30%). The past year saw two big ticket investments in the US from India, namely, USD 1.35 bn investment by Piramal Healthcare and USD 759 mn investment by JSW Steel in their US subsidiaries.

Chart 5
**Tax haven offshore centers - Singapore, Mauritius, Netherlands – account for the bulk of India's ODI**

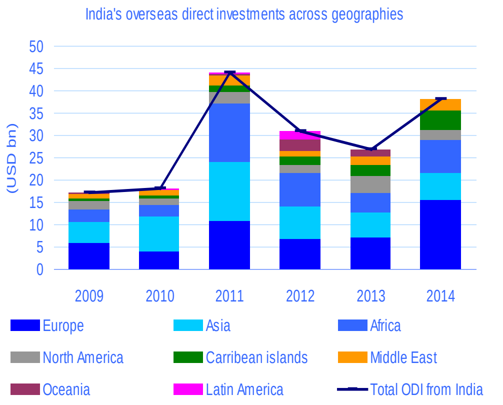



*Fiscal year ending March, Source: BBVA Research, RBI;

Chart 6
**Excluding offshore centres, the US, UK and Australia are preferred investment destinations for Indian ODI**

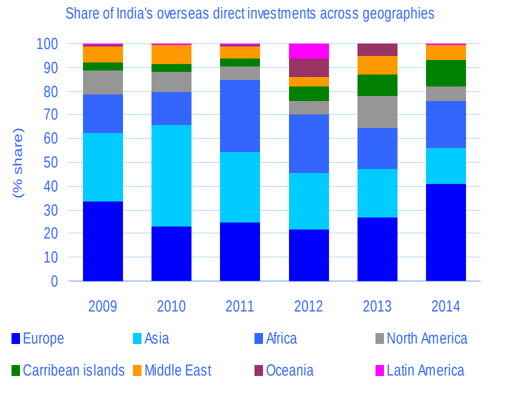

* Fiscal year ending March, Source: BBVA Research, RBI

Chart 7
**We reclassify India's ODI list to include offshore centres based on proximity – Europe tops the list**




*Fiscal year ending March, Source: BBVA Research, RBI

Chart 8
**Europe has fast grown as India's preferred investment destination, followed by Asia and Africa**




* Fiscal year ending March, Source: BBVA Research, RBI

## We reclassify the list of host economies for India's ODI to include offshore centers based on proximity – Europe tops as India's favorite destination

Given the dominant role of offshore financial centers in channeling ODI flows from India, we find it pertinent to include them in our analysis of India's overseas direct investment destinations. We thereby conduct a reclassification exercise based upon the proximity of offshore financial centers. The underlying assumption is that these centers would be used as conduits to mobilize funds and invest in countries within close proximity to the OFC. For example, Singapore acts as a conduit for Asia, Mauritius for Africa, Netherlands for Europe, and British Virgin Islands for the US.

Our study suggests that Europe tops as the favorite investment destination for Indian companies (See Chart-7). Over FY09 to FY14, Europe has received USD 50 bn in ODI flows from India compared to 44 bn in Asia, USD 38 bn in Africa, USD 13 bn in North America, USD 11 bn in the Caribbean Islands, USD 10 bn in the Middle East, USD 4 bn in Oceania and USD 3 bn in Latin America. Flows to Europe jumped last fiscal year to record USD 15.6 bn from USD 7.2 bn in FY13. Within Europe, Euro-zone received the bulk of ODI flows (69%) from India.

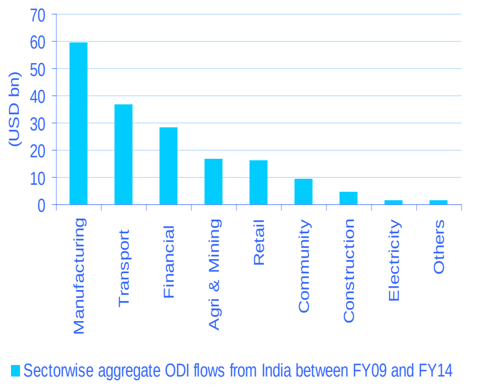
Over the past year, Indian companies have struck 1743 ODI deals in Europe, 60% of them across information technology, Automotive, manufacturing, telecom, financial services and steel. Last year also saw big ticket investments in the renewable energy space with Suzlon, India's major wind turbine supplier, investing USD 675 mn in Netherlands. That said, the largest deal last fiscal year was in the telecom space - a USD 2.2 bn of Euro bond issue by Bharti Airtel, an Indian telecom major, through Bharti Airtel International Netherlands in January 2014.

Meanwhile, Asia's share in India's ODI flows has declined successively since 2010, from 43% to 15% in 2013-14 (See Chart-8). Chiefly, Singapore, which constitutes around 86% of India's ODI flows to Asia, received muted flows in 2013-14 at USD 5.1 bn; much lower than its FY11 peak of USD 12 bn. Excluding Singapore, flows to China and Hong Kong have seen a consistent uptrend since 2008-09, up from USD 133 mn to USD 381 mn in the past fiscal. The share of Latin America in India's ODI remains miniscule at around 1%. Panama attracts nearly 60% of India's ODI flows into Latam, followed by Brazil (15%), Chile (10%) and Mexico (8%).

## Manufacturing has received the largest chunk of ODI flows since 2008, but its share has declined overtime

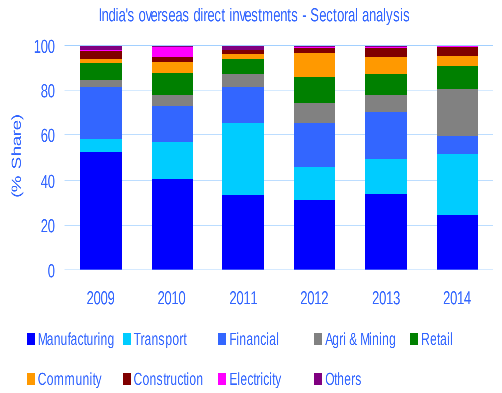
Sector-wise study suggests that manufacturing has received the largest chunk (USD 59 bn) of overseas investments from India during FY09 to FY14 (See Chart-9). The transportation sector stood second (USD 37 bn) followed by financial (USD 28 bn), agriculture and mining (USD 16 bn) and retail (USD 16 bn). The manufacturing sector encompasses large sized acquisitions across steel industry besides food processing, consumer goods, chemicals, pharmaceuticals and automobiles, while the financial sector includes investments by service oriented business houses, particularly across software and information technology. In contrast, outward FDI from China, Indonesia, Chile and Brazil is mainly state-led and into natural resource based industries.

Chart 9
**Since FY09, bulk of ODIs from India have been in the manufacturing sector, followed by transport**




* Fiscal year ending March, Source: BBVA Research, RBI

Chart 10
**But, the share of manufacturing in India's ODI basket is declining, offset mainly by mining and transport**




* Fiscal year ending March, Source: BBVA Research, RBI

### India's widening energy deficit has led to an increase in resource seeking overseas investments

We find a pick-up in resource seeking overseas investments from India in recent years, particularly in the energy space to address India's widening energy deficit. According to the BP Energy Outlook 2035, India's primary energy deficit has more than doubled from 82 million tones of oil equivalent (Mtoe) in 2000 to 219 Mtoe in 2012 and is expected to widen further to 578 Mtoe by 2035. The share of manufacturing sector in India's annual ODI basket has declined noticeably - from 53% in FY09 to 31% in FY11 to 24% last fiscal - and offset mainly by transport and agriculture and mining. Share of the later has surged from 3% to 21% during the same period (See Chart-10).

FY14 saw a record USD 8 bn of aggregate overseas investments in the agriculture and mining sector, which surpassed the combined investment in the sector over the previous three years. Key deals struck last fiscal in the energy space include the acquisition of Videocon Group's 10% stake in a giant Mozambique gas field for USD 2.47 bn by India's public sector energy major ONGC Videsh Ltd (OVL) and OIL India. Additionally, OVL bought US energy major Anadarko Petroleum's 10% stake in the same block for USD 2.64 bn. The acquired block is strategically located to competitively supply LNG to India and marks OVL's entry into an emerging world-class offshore gas basin. Looking ahead, given the scarcity of industrial resources in relation to India's rising demand, we expect Indian public and private sector firms to increasingly seek to tap scarce natural resources abroad, to facilitate industrial development at home.

## Funding India's ODI flows – Rising recourse to bank guarantees

A challenging domestic funding environment - high inflation, rising interest rates and a depreciating rupee – has led Indian companies to increasingly raise funds abroad with credit support from domestic bank guarantees. The share of Indian bank guarantees in funding overseas investments from India has risen rapidly from 6.5% in 2007 to 62% last fiscal year. Consequently, the share of equity funded deals fell from 78% to 28% during the same period (See Chart-11).

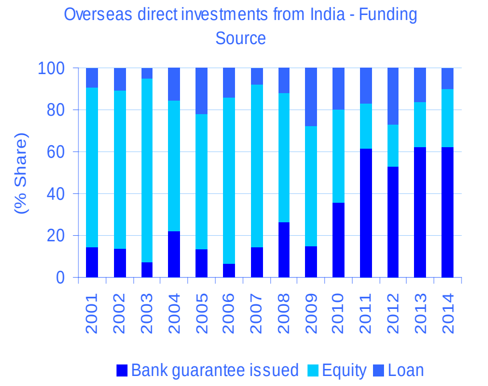
The past year also saw a sharp pick up in the use of external commercial borrowings (ECBs) by Indian companies to fund overseas acquisitions (See Chart-12). However, on a relative scale, the ODI funding through ECBs is low compared to the quantum of overseas investments (6.0% of total ODI flows since 2008). Although rising, India's external debt as a share of GDP is significantly low at 23% and thus does not pose a meaningful credit risk. However, the Reserve Bank of India needs to further boost India's foreign exchange reserves, which are declining as a share of India's external debt (See Chart-13) and could hinder overseas direct investment flows.

## India's strong and stable government can foster two-way capital flows by boosting export performance

A decisive victory for India's chief political opposition party – the BJP alliance, led by Mr. Modi at the recently concluded national elections is a big positive for India's medium to long term growth prospects. Perceived to be reformist and pro-business, the new government with a strong and stable mandate is better placed to address India's protracted macro challenges – elevated inflation, high fiscal deficit, sub-par growth, weakening private investment activity and a leveraged corporate sector. BJP's economic agenda, based on its election manifesto, gives credence to infrastructure development, boosting manufacturing activity and a focus on economic diplomacy for friendly trade policies.

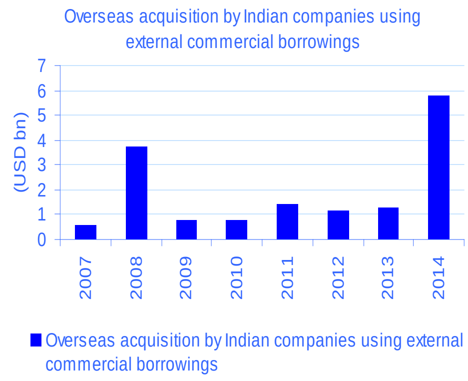
If effectively executed, we believe that the government's policies would bolster India's exports performance and in turn accelerate two-way capital flows over the next five years. Greater trade openness associated with a high degree of export orientation would push more Indian companies to go global as they seek to build scale using global operations and invest abroad so as to protect their export markets. Although growing, India's exports share of GDP is relatively low at 25% and concentrated mainly in low value categories such as engineering goods, textiles, chemicals, agriculture commodities and petroleum products (See Chat-14).

Chart 11
**Reliance on bank guarantees to fund overseas investments from India has increased significantly**



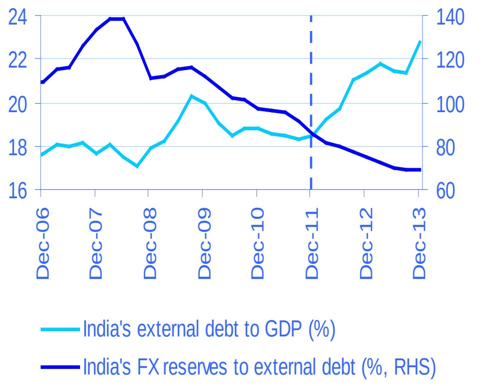

* Fiscal year ending March, Source: BBVA Research, RBI

Chart 12
**Although still considerably low, use of ECBs to fund overseas acquisition rose sharply over the past year**



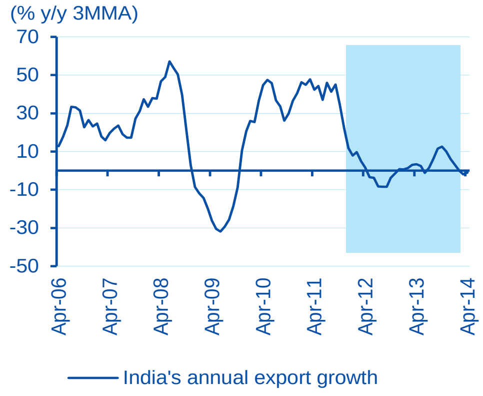

* Fiscal year ending March, Source: BBVA Research, RBI

Chart 13
**Although still at a low level, India's external debt is rising while the reserves to debt ratio has slipped**




Fiscal year ending March, Source: BBVA Research, RBI

Chart 14
**India needs to focus on reinvigorating exports while further raising the foreign exchange reserves buffer**




* Fiscal year ending March, Source: BBVA Research, RBI

## Stronger trade pacts would play a key role in enabling Indian MNCs to go global

Apart from fostering domestic export orientation, the government must focus on cementing existing bilateral and regional trade and investment agreements as also ink new ones so that Indian companies can benefit from reciprocal market access. This requires a dual focus on strengthening regional forums such as SAARC and ASEAN in Asia as also engage proactively in global forums such as BRICS, G20, India-Brazil-South Africa (IBSA), Shanghai Cooperation

Organization (SCO) and Asia-Europe Meeting (ASEM). On the priority list of new free trade pacts is the Regional Comprehensive Economic Partnership (RCEP) and the long delayed India-European Union free trade pact (BTIA - Broad-based Trade and Investment Agreement). The RCEP would foster deeper trade and investment links between the 10 ASEAN member states and those countries who have free trade agreements with ASEAN, namely Australia, China, India, Japan, South Korea and New Zealand.

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