United Nations Conference on Trade and Development

GLOBAL PLAYERS FROM EMERGING MARKETS: STRENGTHENING ENTERPRISE COMPETITIVENESS THROUGH OUTWARD INVESTMENT

UNITED NATIONS

New York and Geneva, 2007

NOTE

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

The designation employed and the presentation of the material in this publication do not imply the expression of any opinion whatsoever on part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area, or of its authorities or concerning the delimitation of its frontiers or boundaries.

UNCTAD/ITE/TEB/2006/9

Preface

The landscape of international investment has taken on an important new dimension in recent years, with the advent and rapid expansion of foreign direct investment (FDI) from developing countries. Total outward FDI (OFDI) by firms from developing and transition economies reached $133 billion in 2005, the highest level ever recorded and 10 times higher than in 1990. This corresponds to about 17 per cent of world outward flows in 2005; in 1990 that share was only 5 per cent. The rise in the number of large transnational corporations (TNCs) from developing and transition economies is a reflection of this trend. For example, in the year 1990, only 19 companies based in developing and transition economies featured in the Fortune 500 list of the world's largest companies; by 2005, that number had risen to 47; and by 2006, it had reached 58. The trend is led by Asia, where three quarters of the top 100 TNCs from developing countries are headquartered, but there are significant numbers of TNCs from Africa and Latin America as well. Beyond the larger companies, there are vast numbers of small and medium enterprises investing abroad. Most investments by enterprises from developing economies go to other developing economies, often in the same region. This facilitates South-South cooperation and can result in the transfer of good practices to host country firms, especially through measures to enhance absorptive capacity.

Many firms from developing countries are now investing abroad to enhance their competitiveness by acquiring market access, technology, skills, natural resources and R&D facilities; they are also improving efficiency and building international brand names. Governments have recognized the developmental impact of this recent phenomenon and have introduced a number of support policy measures, ranging from liberalization and reforms of the regulatory environment to active promotion of OFDI. Regional integration has also played a role in encouraging outward investment by developing country firms.

Developing countries should not fear encouraging their firms, particularly those that possess competitive advantages, to go abroad. However, there is a need to embed specific investment policies that would include both inward and outward investment in a coherent economic development policy framework. In addition, dialogues among stakeholders should increase awareness and understanding of the factors driving OFDI from the South, as well as their potential impacts. There are risks and challenges for developing country enterprises investing abroad. If they are appropriately addressed, the risks of failure can be minimized and the positive impact on development maximized. Building enterprise capacity is one of the key success factors in this regard. This task entails efforts across a wide range of areas, from entrepreneurship and enterprise development to technology and education policy.

UNCTAD and other international organizations have an important role to play in increasing awareness and understanding of this phenomenon by providing analysis, technical assistance and a forum to exchange views and experience, fostering the building of consensus to realize the full benefit of the rise of FDI from developing economies. The development of the domestic industry or service networks, which would be able to link effectively with international production networks, also requires the promotion of entrepreneurship and enhancing competitiveness at firm levels, through technology and business linkages. UNCTAD's EMPRETEC programme has been effective in many countries in helping unleash entrepreneurial potential, introducing behavioural change and promoting the entrepreneurial culture. Business linkages programmes initiated by UNCTAD in various countries have facilitated the upgrading of suppliers and the integration of SMEs in regional or global value chains.

UNCTAD has initiated a broad dialogue to increase awareness and discuss issues on enterprise internationalization through OFDI. In May 2005, UNCTAD jointly organized with Fundação Dom Cabral (FDC) and the Ministry of Development, Industry and Foreign Trade of Brazil a national workshop in São Paulo on Global Players from Emerging Markets, which focused on Brazil's experience. UNCTAD also participated in the forums on internationalization of Chinese firms in April 2005 and 2006 in Beijing. Issues related to enterprise internationalization and the role of OFDI were further discussed in the World Investment Report 2006 and at different intergovernmental meetings that identified the need to continue the policy dialogue and awareness building of this phenomenon at the regional and international levels.

UNCTAD has also conducted an Expert Meeting on Enhancing Productive Capacity of Developing Country Firms through Internationalization, held in Geneva, 5–7 December 2005. During this meeting, OFDI issues were discussed in depth from different perspectives, including those of policymakers, regulators, large and small firms, international organizations, researchers and others. This publication contains proceedings and case studies of this meeting. It is an initial attempt to promote better understanding of enterprise internationalization by developing country firms, including SMEs, through OFDI, especially as it relates to corporate strategies, trends, drivers, challenges, supporting policies and impact on enterprise competitiveness, as well as a base for further research and policy analysis of key issues in this area.

I hope this publication will constitute a useful input towards efforts on building awareness and capacity on enhancing enterprise competitiveness though OFDI.

Supachai Panitchpakdi
Secretary-General of UNCTAD

Acknowledgements

This publication is an initial attempt to promote better understanding of enterprise internationalization by developing country firms, especially on corporate strategies, trends, drivers, challenges and policy measures supporting OFDI. It was prepared by Fiorina Mugione and Kee Hwee Wee under the overall supervision of Tatiana Krylova. The support from the Investment Issues and Analysis Branch of the Division of Investment, Technology and Enterprise Development is gratefully acknowledged. Rosalina Goyena helped with the desktop publishing.

The following authors prepared country case studies for the publication, which were also distributed at the Expert Meeting on Enhancing Productive Capacity of Developing Country Firms through Internationalization, 5–7 December 2005, Geneva: André Almeida, Márcia Tavares, Erika Penido Barcellos, Álvaro Calderón, Sherban Leonardo Cretoiu, Álvaro Bruno Cyrino, Asim Erdilek, Alexe Giroud, Ana Vitória Alkmim de Souza Lima, Kari Liuhto, Hafiz Mirza, Hwy-Chang Moon, Jaya Prakash Pradhan, Caio César Radicchi, Reginald Rumney, Manoj Kumar Sahoo, Peeter Vahtra, Henry Wai-chung Yeung and Zainal Aznam Yusof.

Other authors have also prepared background documents distributed at the above-mentioned Expert Meeting: Federico Bonaglia, Peter Brimble, Andrea Goldstein, John Mathews, Michael Mortimore, Atchaka Sibunruang and Marjan Svetlicic.

CHAPTER VI

OUTWARD FOREIGN DIRECT INVESTMENT BY SMALL MEDIUM-SIZED ENTERPRISES FROM INDIA*

A. Introduction

This paper examines the OFDI behaviour of Indian small and medium enterprises SMEs.[49] The pattern of enterprise internationalization is interesting because India is a developing country that has pursued a long-term policy of protecting and promoting SMEs development. Therefore, the Indian SMEs internationalization experience could be highly relevant for understanding the behaviour and characteristics of OFDI by developing country SMEs. The paper analyses the trends in OFDI by Indian SMEs, the drivers, implications on enterprise competitiveness and finally it reviews OFDI policies.

B. OFDI from India: Trends and development

Indian enterprises have been investing abroad for a long time, but it is only in recent years that Indian OFDI has become sizable. The evolution of OFDI flows from India is captured by the "two waves" trend. The first wave of Indian OFDI is different from the second wave in terms of investment size, growth, geographical spread, sectoral characteristics, pattern of ownership and motivations (figure 1). This "two waves" classification reflects the liberalization of OFDI policy, and changes in the quantum of OFDI flows including the character and motivations of Indian investment abroad.

The second wave is a distinct break from the first in terms of the number of Indian enterprises undertaking overseas production and the size of investment. It was a period of dramatic expansion of Indian OFDI. As at December 1983, there were only 228 approved OFDI projects, compared with 4,533 approved projects during 1997-2004 (table 1). This significant rise in the number of OFDI projects contributed to a 177 times increase in Indian OFDI stock, from $0.037 billion in 1976 to $6.6 billion in 2004 (figure 2).

Indian OFDI has undergone significant changes in sectoral and geographical distribution, types of FDI, structure of ownership participation and financing arrangement in the two different periods.

Geographical distribution. Most of the approved OFDI in the second wave went to the developed countries, which contrasted with the destinations in the first wave (table 2).

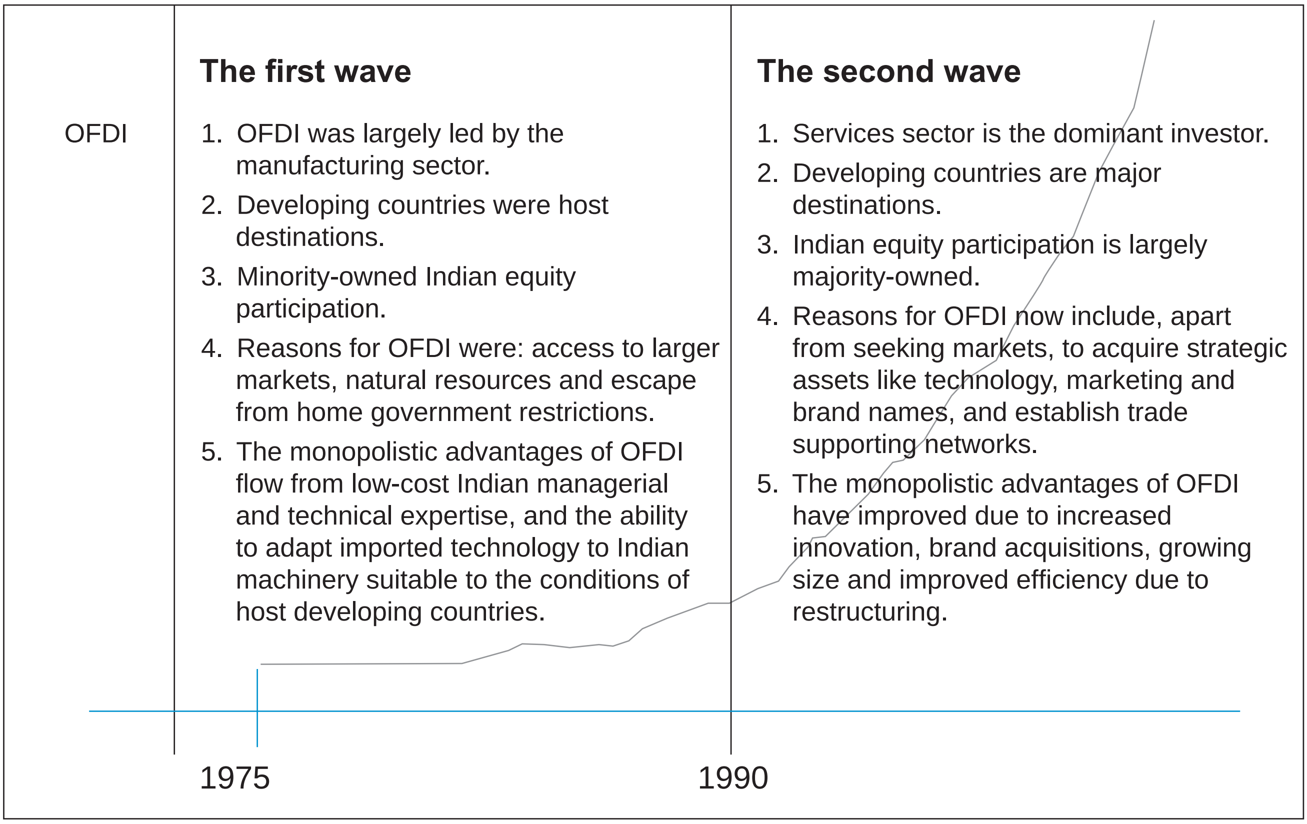
- In the first wave, developing South-East and East Asia were the largest host regions, followed by Africa, West Asia, Central Asia and South Asia in that order (figure 4).

- During the second wave, Western Europe and North America emerged as the major host regions, accounting respectively for 34 and 24 per cent of total Indian OFDI equity. Among the developing regions, South East Asia witnessed the largest decline in share, from 36 down to 9 per cent. Two developed countries, namely, the United Kingdom (27 per cent) and United States (24 per cent) were the major destinations for Indian OFDI in the second wave.

* This paper was prepared by Jaya Prakash Pradhan, Gujarat Institute of Development Research and Manoj Kumar Sahoo, Centre for Economic Studies and Planning, Jawaharlal Nehru University, India.

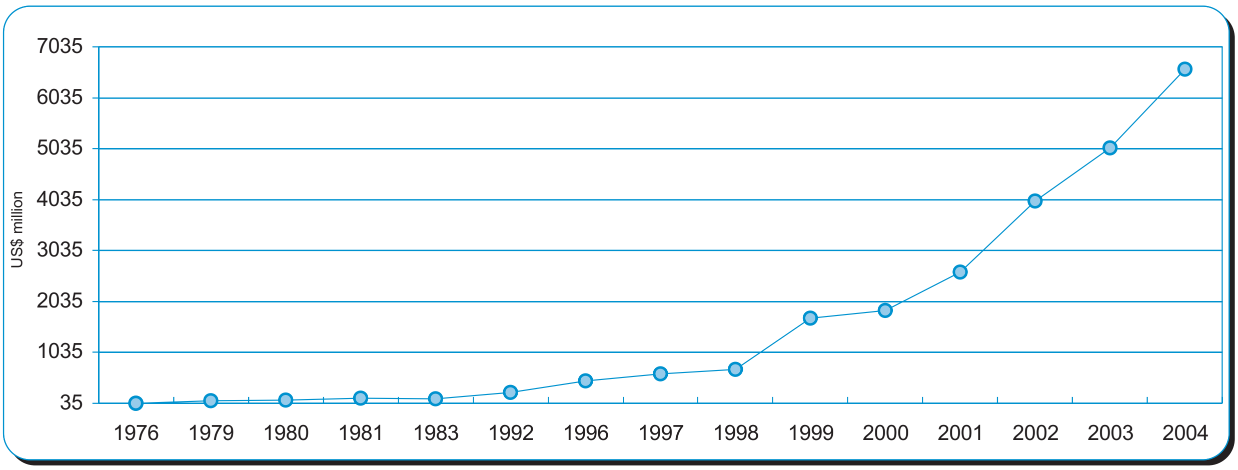
[49] For the purpose of this paper, firms are classified into small, medium-sized and large firms according to the following rule: for an industry (defined as the 3-digit level of International Standard Industrial Classification Revision 3), firms with sales up to the 25th percentile are taken as small, those having sales greater than the 25th percentile and up to the 75th percentile are classified as medium-sized and those with sales greater than the 75th percentile are designated as large enterprises.

Figure 1. The evolution of Indian OFDI from "first wave" to second wave"



Source: Pradhan (2005).

Figure 2. OFDI stock of India, 1976-2004
(Millions of dollars)



Source: Based on table 1.

Table 1. India: OFDI stock, 1976-2004

(Millions of dollars; number)

Period	Direct investment abroad	Equity capital and reinvested earnings	Claims on affiliated enterprises	Other capital	No. of OFDI projects
Jan. 1976	37	37	..	7	133*
Jan. 1979	86	86	..	..	..
Jan. 1980	101	101	..	..	192*
Dec. 1981	135	135	..	..	204*
Dec.1983	120	120	..	..	228*
March 1992	247	247	..	..	..
March 1996	481	481	..	..	..
March 1997	617	617	617	..	..
March 1998	706	706	706	..	..
March 1999	1 707	1 707	1 707	..	..
March 2000	1 859	1 858	1 858	..	..
March 2001	2 615	2 541	2 541	74	..
March 2002	4 005	3 810	3 810	195	..
March 2003	5 054	4 753	4 753	301	..
March 2004	6 592	6 211	6 211	381	4 533

Source: RBI releases International Investment Position (InIP) as on March 2003, Press Release: 2003-04/441; RBI releases International Investment Position (InIP) at India as at end March 2004, Press Release: 2004-2005/359; Reserve Bank of India Bulletin (2000) census of India's Foreign Liabilities and Assets as on March 31, 1997, pp. 1018-1021; Commerce Ministry as reported in R. B. Lall (1986), *Multinationals from the Third World*, table 2.1, p. 14, OUP, Delhi.

Notes: Figures for 1976-1983 include only equity capital; *indicates the stock of OFDI project accumulated over the past whereas @ indicates the cumulative number of approved OFDI projects from 1997 to 2004. The number of year-wise OFDI approvals has been obtained from Finance Ministry at http://finmin.nic.in/the_ministry/dept_eco_affairs/investment_div/idi_05Jan2004.*htm*.

.. means data not available for the corresponding year indicated in the table.

Table 2. Cumulative OFDI approvals by Indian enterprises, 1975-2000

(Millions of dollars; number; percentages)

Period	*Total*		*Sectoral distribution*						*Regional distribution*			
			Extractive		Manuf.		Services		Developing countries		Developed countries	
	No.	Equity	No.	Equity	No.	Equity	No.	Equity	No.	Equity	No.	Equity
1975-90 (First wave)	230 (100)	222.45 (100)	3 (1.3)	4.04 (1.8)	128 (55.7)	145.22 (65.3)	99 (43.0)	73.22 (32.9)	165 (72.0)	191.52 (86.1)	64 (27.9)	30.89 (13.9)
1991-2000 (Second wave)	2 561 (100)	4 262.23 (100)	7 (0.3)	61.14 (1.4)	1 236 (48.3)	1 678.92 (39.4)	1 318 (51.5)	2 522.17 (59.2)	1 176 (45.9)	1 719.82 (40.3)	1 386 (54.1)	2 542.6 (59.6)
1975-2000	2 791 (100)	4 484.68 (100)	10 (0.4)	65.18 (1.4)	1 364 (48.9)	1 824.14 (40.7)	1 417 (50.8)	2 595.39 (57.9)	1 341 (48.0)	1 911.34 (42.6)	1 450 (51.9)	2 573.49 (57.8)

Source: UNCTAD's estimates based on RIS OFDI database (2002).

Notes: In parentheses are percentage shares of the total.

The Research and Information System for the Non-Aligned and Other Developing Countries (RIS) had made an attempt to compile firm-level information on Indian OFDI from unpublished information of the Ministry of Commerce and published reports from the Indian Investment Centre. The compiled information covers a long period from 1975 to March 2001 in the evolution of Indian OFDI. This dataset takes account of only the approved equity capital for projects in production and under implementation, not actual, and does not cover reinvested earnings and other capital.

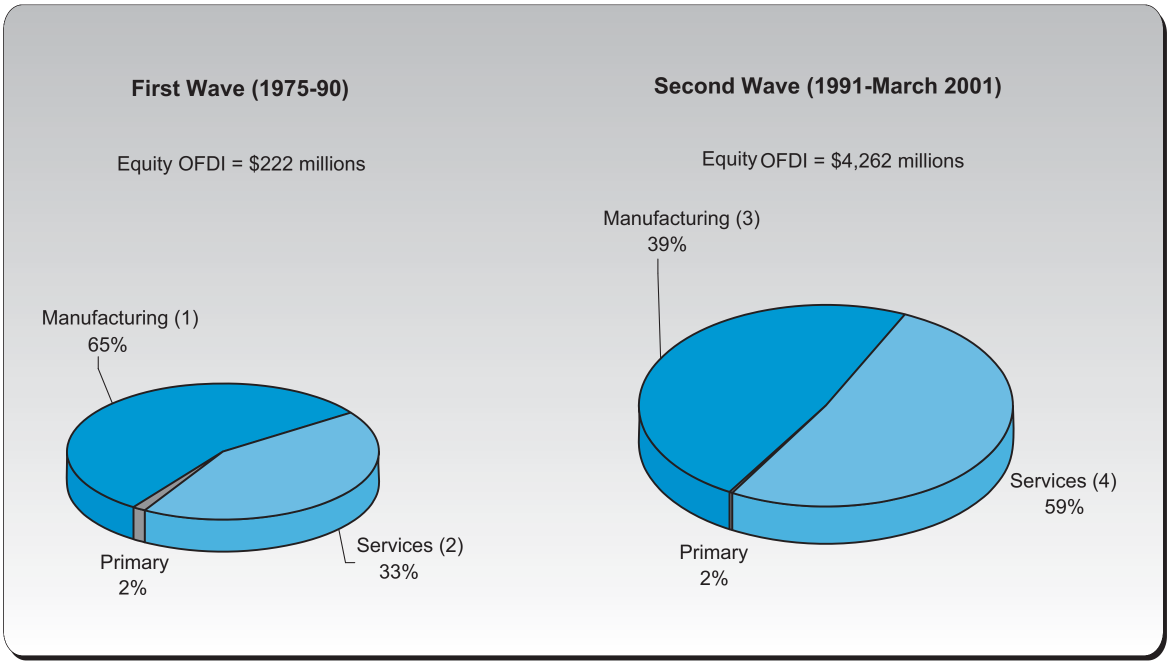
Sectoral distribution. In the first wave, Indian manufacturing enterprises were the largest investors abroad and in most cases firms invested in other developing countries with similar or lower level of economic development than India. The manufacturing industry accounted for the lion's share of Indian OFDI approvals (table 2). The services industry accounted for about 33 per cent of the approvals in terms of equity value, while the extractive sector accounted for less than 2 per cent.

Low- and middle-ranking technology manufacturing industries such as fertilizer and pesticides (18 per cent), leather (9 per cent), iron and steel (7 per cent), and wood and paper (5 per cent) were the main industries investing abroad in the first wave. The three leading service industries in that period were financial services and leasing (12 per cent), hotels and tourism (11 per cent), and trading and marketing (6 per cent) (figure 3).

- In the second wave, approved OFDI equity value of service industries rose to 60 per cent and it constituted 52 per cent of OFDI approvals (table 2). The Indian information and telecommunication (IT) industry emerged as the largest source of Indian services OFDI, accounting for 32 per cent of total flows, followed by media, broadcasting and publishing (17 per cent). The leading manufacturing OFDI sources were fertilizers and pesticides and pharmaceuticals. Recent years saw a significant increase in natural resources OFDI from India, contributed by acquisitions made by such companies as ONGC-Videsh.

Types of OFDI. Another significant feature of the second wave is the emergence of M&As as an important mode of internationalization by Indian enterprises. The late 1990s saw a surge in overseas acquisitions by Indian enterprises. As many as 119 overseas acquisitions were made by Indian enterprises

Figure 3. India: OFDI flows, by industrial distribution, 1975-1990 (first wave) and 1991-March 2001 (second wave)



Source: Research and Information System for the Non-Aligned and Other Developing Countries (RIS) OFDI database.

Notes:

(1) Three industries accounted for the lion's share fo the manufacturing OFDI. They were fertilizers, pesticides and seeds accounted for 18%; leather, shoes and carpets (9%) and iron and steel (7%) of equity OFDI.

(2) Three industries accounted for the majofr share of services OFDI. They were financial services (12%); hotels, restaurants, tourism (11%) and trade and marketing (6%) of total equity OFDI.

(3) Three industries accounted for the bulk of the manufacturing OFDI during this period. They were: Fertilizers, pesticiides and seeds (8%); drugs and phamaceuticals (6%); and textiles and garments (3%)

(4) Two industries accounted for the major part of services OFDI. They were: IT, communication and software (32%) and media broadcasting and publishing (17%).

Table 3. Overseas M&As by Indian enterprises, 2000-2003

(Number; percentage)

Sectoral composition			*Regional composition*		
Sector	*No.*	*Per cent*	*Region*	*No.*	*Per cent*
Primary	9	7.6	Developed countries	93	78.2
Mining, petroleum and gas	9	7.6	United Kingdom	16	13.4
Industry	34	28.6	United States	53	44.5
Pharmaceuticals	12	10.1	Australia	8	6.7
Paints	4	3.4	Developing countries	20	16.8
Plastic & products	4	3.4	Africa	5	4.2
Services	76	63.9	Latin America and the Caribbean	3	2.5
Software	67	56.3	Asia and the Pacific	12	10.1
All sectors	119	100	All regions	119	100

Source: Based on Pradhan and Abraham (2005).

in 2002-2003. The key characteristics of Indian M&As in the second wave include:

- Most of the acquisitions were in the software industry, followed by pharmaceutical and mining activities (table 3).
- The lion's share of the M&A purchases was in developed countries, dominated by the United States and the United Kingdom.
- Indian enterprises are increasingly using M&As to venture abroad to access market, technology, strategic assets and benefits from operational synergies.

Ownership participation. The structure of Indian ownership participation has also undergone a complete shift in the second wave as compared with the previous pattern. While the share of minority ownership[50] OFDI projects declined from 64 per cent to only 24 per cent, the share of majority ownership[51] increased from 13 to 57 per cent (table 4). The removal of policy restrictions on ownership participation during the second period and the desire of Indian companies to have full ownership explain this phenomenon.

Financing arrangements. The unprecedented growth of OFDI during the second wave is accompanied by significant changes in the financing patterns of OFDI. Earlier, OFDI operations were financed largely through equity investment from the home country. Following the liberalization of OFDI policy, Indian companies expanded their foreign production activities, which were financed through reinvestment earnings. The share of re-invested earnings emerged as the most important component of OFDI flows, accounting for about 45-50 per cent of the total flows during the fiscal years 2000-2001 and 2002-2003 (table 5). It also implies that Indian firms are increasingly more confident with internationalization.

C. OFDI by Indian SMEs

Indian SMEs are not far behind the large enterprises in OFDI activities. For instance, OFDI approvals by SMEs accounted for 26 per cent of cases of manufacturing activities and 41 per cent of cases in the software industry. Software SMEs contributed significantly to OFDI stock (47 per cent), however manufacturing OFDI by SMEs was small (table 6). SMEs in the software industry are largely more internationalized than SMEs in manufacturing activities. This reflects the competitiveness of Indian SMEs in software activities. The fact that the software industry is a skill-intensive industry and it is largely dependent upon foreign markets encouraged Indian SMEs to operate abroad.

[50] Less than 50 per cent of equity ownership.

[51] Greater than 80 per cent of equity ownership.

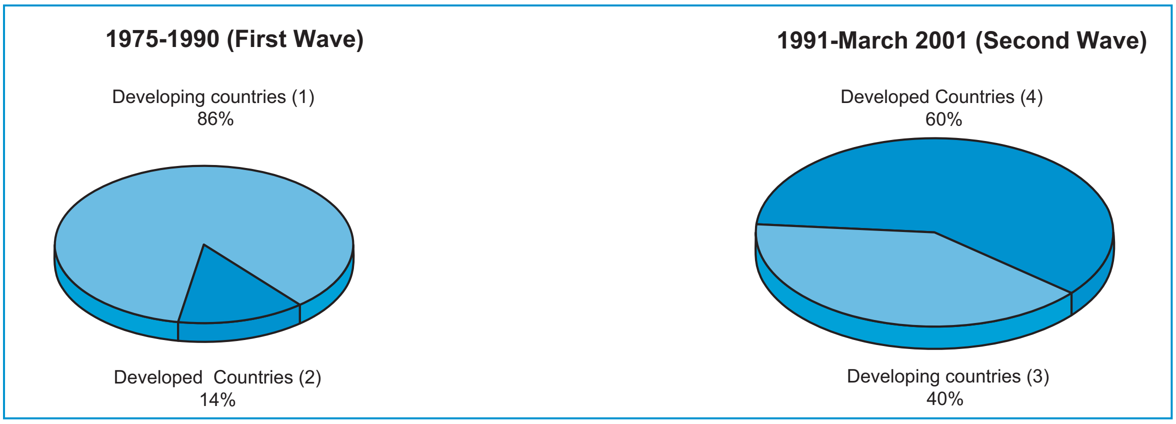
Table 4. The second wave and changing ownership structure of Indian OFDI

(Number; percentage)

Equity range (%)	First Wave (1975-90)			Second Wave (1991 - March 2001)		
	No of OFDI Approval	Per cent	Cumulative per cent	No. of OFDI Approval	Per cent	Cumulative per cent
0 to 20%	51	22.9	22.9	41	3.7	3.7
20 to 50%	91	40.8	63.7	230	20.6	24.2
50 to 80%	53	23.8	87.4	211	18.9	43.1
80 to 100%	28	12.6	100	637	56.9	100
Total	223	100		1119	100	

Source: UNCTAD's estimates based on RIS OFDI database (2002).

Figure 4. India: OFDI flows, by geographical distribution, 1975-1990 (first wave) and 1991-March 2001 (second wave)



Source: Research and Information System for the Non-Aligned and Other Developing Countries (RIS) OFDI database.

Notes: The dataset was compiled at RIS from published reports of the Indian Investment Centre and unpublished data from the Ministry of Commerce.

(1) Three subregions accounted for the bulk of first wave OFDI. They were Southeast and East Asia (36%), Africa (17%) and Central Asia (10%).

(2) Western Europe (8%) and North America (6%) were the two main developed countries destination for first wave Indian OFDI.

(3) Africa subregion accounted for 12%, Southeast and East Asia (9%) and Central Asia (9%) of the second wave OFDI.

(4) OFDI to developed countries surged during the second wave. Western Europe accounted for some 34% share and North America (24%).

Table 5. Distribution of Indian OFDI flows by components, fiscal year 2000-2003

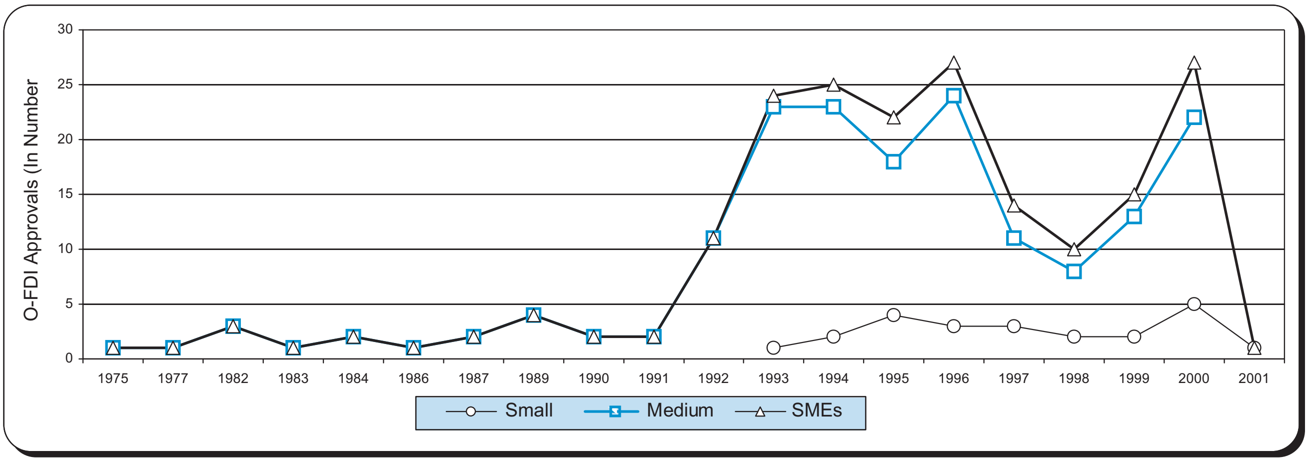
(Percentage)

	FY 2000/2001	*FY 2001/2002*	*FY 2002/2003*
Total OFDI	100	100	100
(i) Equity	45	41	40
(ii) Reinvested earnings	45	50	49
(iii) "Other capital"	10	9	10

Source: Revised Data on Foreign Direct Investment, press release of the Ministry of Commerce and Industry, 30 June 2003.

Figure 5. OFDI approvals by Indian manufacturing SMEs, 1975 - March 2001

(Number)



Source: ibid.

Table 6. OFDI stock, by firm sizes, as at 31 March 2001

(Millions of dollars; number; percentage)

Sector[a]		Firm size				
		Small	Medium	SMEs	Large	Total
Manufacturing	No.	23 (3.08)	172 (23.06)	195 (26.14)	551 (73.86)	746 (100)
	Value	5 (0.32)	99 (6.37)	104 (6.69)	1450 (93.31)	1554 (100)
Software	No.	16 (5.44)	105 (35.71)	121 (41.16)	173 (58.84)	294 (100)
	Value	10 (1.16)	396 (46.10)	405 (47.15)	454 (52.85)	859 (100)

Source: UNCTAD's estimates based on RIS OFDI database (2002).

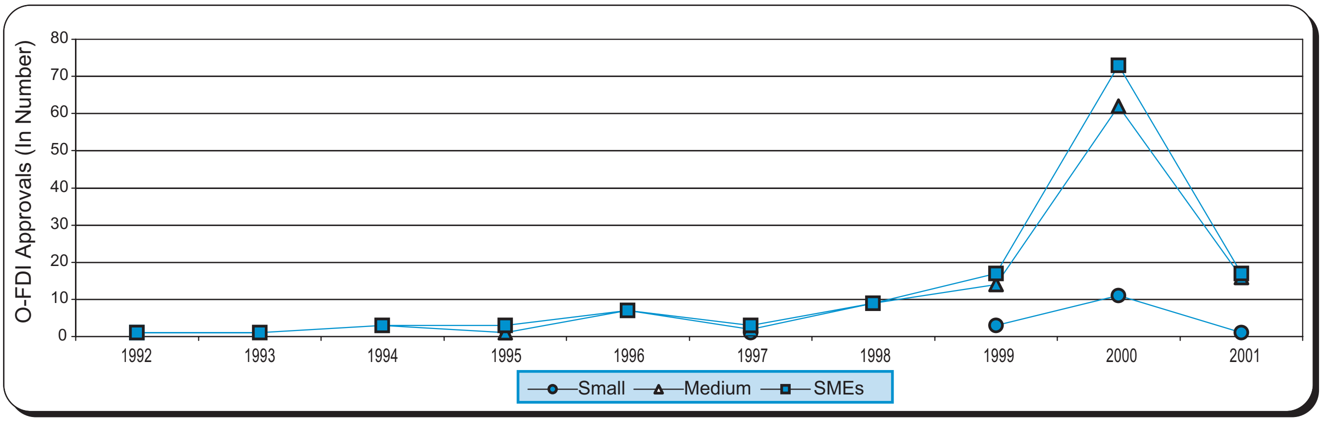
Note: Percentages are in parentheses. [a] Owing to the lack of data on OFDI by SMEs, the authors constructed a database which classified OFDI by firm size by merging firm names from the Prowess database of the Centre for Monitoring the Indian Economy with information from government sources and the dataset from the Research and Information System for the Non-Aligned and Other Developing Countries (RIS). The merging was done at firm level to ensure that recent changes in firm's names and their abbreviations are correctly incorporated when classifying OFDI by firm sizes. Manufacturing and software were selected because they are the two largest investors from the Indian economy.

Indian manufacturing SMEs investment abroad can be traced back to two different time periods. The OFDI process for medium-sized enterprises started when Indian Hume Pipe Company Ltd. commissioned a joint venture in Sri Lanka to manufacture hume pipes in 1975. However, the earliest case of OFDI by small enterprises was a joint venture between Roto Pumps & Hydraulics (P) Ltd. and Sterling Ltd. (United Kingdom) to manufacture pumps in 1993. OFDI by manufacturing SMEs became notable since 1991 when 177 overseas projects by SMEs were approved within a period of 10 years (figure 5). The approved projects cover such industries as light engineering, auto pumps and spares, electrical equipment, textiles and garments, and pharmaceuticals. OFDI by software SMEs, similar to manufacturing SMEs, became prominent since the 1990s, which coincided with the second wave of Indian OFDI (figure 6).

There are several reasons for the difference between SMEs' OFDI behaviour and that of large enterprises. SMEs have insufficient resources to meet the costs of information collection (e.g. foreign markets, government regulations, consumer preference) and are less able to withstand the uncertainty and risk associated with OFDI activities. Because of these disadvantages, SMEs investments are invariably small in quantity as compared with

Figure 6. OFDI approvals by Indian software SMEs, 1992 - March 2001

(Number)



Source: ibid.

OFDI by larger enterprises. Further, the quality and quantity of firm-specific assets owned are also different between SMEs and larger enterprises. SMEs are less likely to be motivated to undertake OFDI for reasons of exploiting its competitive advantages. On the contrary, OFDI is more likely to be undertaken for the purpose of accessing foreign technologies or building trade-supporting infrastructures overseas. As OFDI by Indian SMEs is a relatively recent phenomenon, they might not have a well-planned strategy vis-à-vis the global market, compared with TNCs.

Indian manufacturing SMEs are relatively younger, are less able to undertake R&D and import foreign technologies, are less oriented towards selling activities and have lower profit margins than larger enterprises. In the software sector, SMEs are relatively younger and have a higher R&D intensity but lower technology import intensity, compared with the larger enterprises. While SMEs in the software sector are less export-oriented in their OFDI activities, compared with larger ones, they are relatively more export-oriented in the manufacturing sector. The geographical and sectoral distribution is as follows:

Geographical distribution. Indian manufacturing SMEs invest in both developed and developing economies. Within the developing region, South-East and East Asian countries were the most favoured locations. They accounted for 17 per cent and 24 per cent respectively of OFDI approvals and stock. The Western European countries emerged as the principal destination among the developed countries followed by North America. For software SMEs, the developed countries were the most favoured destinations. Within developing countries, South-East and East Asia were popular locations. North America emerged as the most important investment destination among the developed countries. The United States and United Kingdom were the two largest destinations for OFDI by both Indian TNCs and SMEs. This suggests that Indian SMEs are not shying away from investing in developed countries even though they possess lower levels of technological, brand and skill advantages vis-à-vis Indian TNCs and developed country enterprises. In fact, the lack of these specific advantages was a key reason driving these Indian SMEs to invest in developed countries to augment the advantages.

Industry distribution. Indian OFDI by SMEs is similar to that by large Indian TNCs and covers a broad spectrum of manufacturing industries. SMEs are visible in low-technology-intensive industries (food products, textiles and paper) and in high-technology-intensive industries (pharmaceuticals, office machinery and communications). OFDI by SMEs is prominent in such industries as textiles, leather, footwear, machinery and equipment and motor vehicles. Indian SMEs, namely A C E Laboratories Ltd. (pharmaceutical) and R E P L Engineering Ltd. (electrical engineering), have emerged as top Indian manufacturing SMEs with more OFDI proposals than others.

Cross-border M&As. Overseas M&As by Indian SMEs have been small, particularly in the manufacturing industry. A number of overseas acquisitions by Indian SMEs were in the software industries including SMEs such as Aftek Infosys Ltd., Datamatics Technosoft Ltd., KLG Systel Ltd., Leading Edge Infotech Ltd. and Moschip Semiconductor Technology Ltd.

D. Drivers and motivations

During the first wave, Indian OFDI was mostly driven by the desire to escape the restrictive investment environment at home. The sluggish growth in domestic demand and restrictive government regulations encouraged many Indian enterprises to seek OFDI as an alternative route for growth (Lall 1983). Attractive growth prospects in overseas markets motivated Indian OFDI during this period, as did the need to secure natural resources. The motivations of OFDI changed radically during the second wave. Along with the traditional objective of exploiting overseas markets and securing natural resources, the drivers of OFDI expanded to include:

- accessing/acquiring firm-specific intangibles such as technology, skills and marketing expertise,
- establishing trade-supporting infrastructure, and
- circumventing emerging regional trading arrangements (Pradhan and Abraham 2005).

The relaxation of exchange controls and the significant liberalization of OFDI policies in the 1990s played an important role in encouraging Indian enterprises to invest abroad. More recently, the encouragement provided by the Government has also played a key role. Increasing global competition and the need to establish a firm global position have encouraged Indian enterprises to invest abroad to acquire brand names and production facilities.

E. OFDI and implications for enterprise competitiveness

This section highlights implication for competitiveness, with a focus on SMEs. Whether OFDI for an individual firm is largely beneficial depends upon firm-specific strategies pursued. SME that diversify into too many business activities or product lines and spread its limited financial skill and manpower resources too thin, such as the case of REPL Engineering Ltd., which entered into various joint venture arrangements with other foreign companies abroad, is more likely to face critical survival issues. Without a sound growth strategy pursued in the domestic market, moving abroad would expose an SME to more risk than it can manage. Over-exposure to OFDI activities could lead to inefficiency and decline in competitiveness. Notwithstanding obstacles faced by Indian firms, there was anecdotal evidence indicating that enterprise internationalization has helped some Indian SMEs to become more competitive. For instance, OFDI has helped develop the export competitiveness of Indian manufacturing SMEs and their R&D intensity[52] as compared with those SMEs that did not invest abroad, although profitability did not seem to change through the internationalization process (table 7). Indian manufacturing SMEs are undertaking, in most cases, trade-supporting OFDI activities by establishing distribution and marketing centres in overseas market, enhancing their capability to ensure better sales and after-sales services. In this way, the foreign affiliates of Indian manufacturing SMEs appear to have played a significant role in enhancing export performance.

- **Market access.** The case studies of seven Indian SMEs reveal interesting insights into the nature and impact of their OFDI operations.[53] OFDI undertaken by Indian SMEs has been primarily aimed at strengthening their export performance. Indian SMEs, unlike their TNC counterparts, do not possess the necessary firm-specific competitive advantages to exploit value-adding activities abroad. SMEs such as ACE Laboratories Ltd., Roto Pumps Ltd. and CGVAK Software & Exports Ltd. indicated that they are using OFDI as a strategy to enhance marketing and trade-supporting networks overseas. Roto Pumps Ltd, in particular, used OFDI strategy to build marketing and warehouses overseas. Liberty Shoes Ltd., an affiliate of an Indian TNC, used OFDI to establish retail outlets overseas. In this regard, OFDI has helped expand the market scope and access to new markets overseas for these SMEs.

- **R&D.** Superhouse Ltd. demonstrated that Indian SMEs are also internationalizing their innovation activities, creating new assets. This confirms that internationalization of R&D is not only a strategy of developed country enterprises: less technologically advanced firms from developing countries may also adopt it and gain benefits from well-developed research infrastructures and availability of skilled manpower in overseas markets. In the software industry, Aftek Infosys showed that Indian SMEs are first movers in adopting overseas acquisition strategy. Aftek Infosys

[52] Measured as in-house R&D expenses as a percentage of sales to represent a firms indigenous technological activities.

[53] These cases are ACE Laboratories, REPL Engineering, Liberty Shoes, Roto Pumps, Superhouse, Aftek Infosys and CGVAK Software & Exports reported in an earlier version of the paper (TD/B/COM.3/EM.26/2/Add2) prepared for the UNCTAD Expert Meeting on "Enhancing the Productive Capacity of Developing Country Firms through Internationalization", Geneva, 5-7 December 2005.

Table 7. Export intensity, profitability and R&D intensity of Indian manufacturing SMEs, 1991-2001

Year	Outward investing				Non-outward investing			
	No. of Firms	Export Intensity (%)	Profitability (%)	R&D Intensity (%)	No. of Firms	Export Intensity (%)	Profitability (%)	R&D Intensity (%)
1991	44	7.950	4.753	0.344	966	2.997	4.473	0.013
1992	51	11.264	4.225	0.025	1143	3.670	1.945	0.049
1993	73	14.060	3.974	0.029	1439	4.224	1.947	0.102
1994	102	20.920	6.366	0.254	1931	5.243	4.517	0.115
1995	106	20.812	7.066	0.411	2385	6.380	7.136	0.192
1996	110	21.718	4.914	0.433	2509	6.922	4.450	0.235
1997	101	18.404	2.394	0.184	2555	6.985	3.343	0.227
1998	96	20.388	-2.809	0.326	2550	7.663	2.271	0.251
1999	103	22.204	0.129	0.294	2554	7.343	1.600	0.205
2000	104	21.333	0.485	0.136	2551	6.940	3.467	0.162
2001	83	21.978	5.090	0.461	1938	8.710	6.420	0.186

Source: Computation based on Prowess Database (2002) and RIS OFDI Dataset.

used M&As strategy to access the European market and technology overseas to improve its competitiveness.

Lesson learned. A number of strategic lessons could be considered by enterprises that explore internationalization strategies through OFDI:

Enterprises constrained by size and resources should not diversify production activities into a variety of products internationally. Specializing in a niche product is a good strategy for incremental internationalization rather than spreading the limited resources too thinly on many products and to many places.

Enterprises operating in a particular product category could come together, collaborate and pool their resources for creating their own respective niche market segment. The need for an interactive platform that enables enterprises, particularly SMEs to share information, learning and jointly developed differentiated products can go a long way in overcoming their size limitations.

Indian enterprises could consciously invest in new technologies, particularly ICT. This is most critical as it enables them to access information on global markets, regulations and finding business partners abroad.

Indian enterprises could improve their capabilities and internationalization capacity by upgrading their technology, product differentiation and management skills in collaboration with business schools and management institutions.

Indian enterprises with easy access to finance or in a strong financial position could consider internationalization through using M&As. Indian enterprises could also observe good corporate governance and contribute to the host country's national development.

F. OFDI policies

India's OFDI policy regime, 1978-2004[54]. India's policy regime for OFDI has been changing since 1978 when the concrete guidelines for Indian joint ventures (IJVs) and wholly owned affiliates abroad were issued. Although overseas investment was permitted before 1978, the Indian policy regime was yet to be shaped.

Two distinct phases in the evolution of Indian OFDI policy can be distinguished: the period between 1978 and 1992, when the 1978 guidelines stayed in place throughout, with minor revisions; and the period

[54] This discussion draws heavily on Pradhan (2005).

following 1992, when new guidelines for OFDI were brought in. While the first phase was characterized by a restrictive attitude towards OFDI, the second phase was marked by large-scale policy liberalization (box 1).

Indian OFDI in the 1990s grew dramatically after the implementation of the economic liberalization policy in 1991, which resulted in intense competition for survival and growth among firms. Indian firms, including SMEs, also faced competition from abroad as a result of globalization. The Government subsequently relaxed restrictions on Indian OFDI. The increasing competitive pressure at home and abroad, and the liberalization of OFDI, played an important role in driving Indian OFDI.

- ***The first phase.*** During the first phase of its evolution, the government policy towards OFDI had been motivated by two main objectives:

(i) using OFDI as a strategy for fulfilling India's commitment to South-South cooperation; and

(ii) promoting Indian exports through OFDI at minimum possible foreign exchange cost.

OFDI was regarded as a vehicle to share India's development experience, technology and skills with other developing countries. The early OFDI policy explicitly required that Indian equity participation comply with the rules and regulations of the host country. The early policy also sought to promote OFDI only in the form of joint ventures with minority Indian ownership participation. The promotion of joint ventures ensured that local capital also participated with Indian capital in the development process of host countries. In addition, there were concerns of minimizing foreign exchange costs. To further minimize these costs, the policy required that Indian ownership participation be in the form of capitalization of exports or financed by Indian-made plant, machinery and know-how. The motivation for minimizing foreign exchange costs also found its practical form in not permitting cash remittances for OFDI, except for deserving cases.

Box 1. Salient features of different phases of OFDI policy

	Phase I: 1978-1992	Phase II: 1992 onwards
Policy objectives	• Promoting Indian OFDI as a tool of South-South cooperation • Maximizing economic gains (mainly exporting of machinery and know-how) from OFDI at minimum foreign exchange costs	• Promoting OFDI as a tool of global competitiveness • Maximizing exporting from India, acquiring overseas technology, gaining insider status in emerging trading blocs, etc.
Strategies	• Permission only for minority-owned joint ventures (JVs)	• Removal of ownership restrictions in overseas ventures
	• Equity participation should be through exports of Indian-made capital equipment and technology • Capitalization of export of second-hand or reconditioned machinery against foreign equity is prohibited • Cash remittances, except in deserving cases, are normally not permitted	• Foreign equity participation normally is allowed through cash transfer along with the usual way of capitalization of exports of plant, machinery and know-how. • Equity participation through export of second-hand or reconditioned machinery is permitted • Equity participation through the ADR/GDR route is allowed
	• Overseas JVs must be in the same line of business activity	• OFDI can be in any bona fide business activity
	• OFDI is permitted only through the normal route [a]	• Automatic route under Reserve Bank of India (RBI) is instituted for OFDI approval along the normal route.

Source: Authors.

[a] There are two different routes for OFDI: the automatic and the normal. For a speedy and transparent approval system, the automatic clearance route was put in place for a specified investment limit. Under this route no prior approval from the regulatory authority such as the RBI or Government of India is required for setting up a joint ventures or a wholly owned affiliate abroad.

- ***The second phase.*** After pursuing a restrictive policy regime during the 1970s and 1980s, India shifted to a new, transparent and liberal OFDI policy regime during the 1990s. By the 1990s India had attained a higher level of development with strong competencies in knowledge-based industries such as pharmaceuticals, software and automobiles. It had accumulated significant levels of technological expertise and knowledge, entrepreneurial development, management skill and infrastructure.

The guidelines for joint ventures and wholly owned enterprises were issued in October 1992 with the objective of making OFDI policy regime more transparent and commensurate with current global developments and Indian business realities. It is now motivated to use OFDI in promoting exports, acquiring technology abroad, building trade-supporting networks and gaining insider status in emerging trading blocs with the strategic objective of global competitiveness. The 1992 policy removed the restriction on ownership participation and the Indian entity is free to decide on the exact level of ownership it wants to hold in overseas ventures. For a speedy and transparent approval system, the automatic clearance route under RBI was put in place for a specified investment limit. Under this route no prior approval from the regulatory authority such as the RBI or Government of India is required for investing abroad.

The amount of direct investment under automatic approval was raised continuously from $2 million in 1992, $15 million in 1995, $100 million in 1999 and any amount up to 200 per cent of their net worth in 2005. Indian firms operating in the Special Economic Zone are allowed to make overseas investments with no limit on the amount invested under the automatic route. Investments under the automatic route have also been allowed in unrelated business from the investing firm and in new sectors such as agricultural activities.

OFDI policy regime and SMEs. As the existing Indian OFDI policy permits only those corporate entities and partnership firms that are registered under the Indian Factories Act, 1956, and the Indian Partnership Act, 1932, it prevents the largest chunk of SMEs operating in the unorganized segment of overall Indian manufacturing industry from undertaking OFDI operations. However, SMEs, which are classified under organized manufacturing, are legally eligible to undertake investment abroad.

During much of the first phase of policy evolution, SMEs faced policy constraints on their OFDI as equity participation has to be in terms of exporting indigenous machinery, equipment and technical know-how. SMEs during that phase were not original equipment manufacturers and did not possess the required technological capabilities to undertake OFDI. During the second phase, however, the previous restrictions that supported SMEs internationalization through OFDI were relaxed. However, many of the liberalized provisions such as liberal access to overseas financial markets and international securities markets did not help SMEs to engage in OFDI, as many of them did not have the capability to do so. Resource-constrained SMEs also did not benefit much from the increase in the cap on investment limit.

G. Conclusion

Indian OFDI activities have emerged as distinguishing features of the Indian economy since the 1990s. The number of OFDI approvals, as well as the size of OFDI flows, has increased significantly in the past decade. This new wave of OFDI, termed the second wave, was accompanied by significant changes in the structure, characteristics and motivations which differ from those of OFDI in the pre-1990s.

OFDI from India has not been entirely led by large enterprises. Indian SMEs have also played a significant role. Indian OFDI by SMEs has been growing since the 1990s, a trend that is relevant in both the manufacturing and software industries. OFDI by Indian manufacturing SMEs is visible in both the low- and high-technology intensive industries. Indian SMEs invest in both developed and developing countries, but the software OFDI is more inclined to favour the developed region. There is also a growing tendency for Indian SMEs, as for TNCs, to pursue overseas acquisitions to expand markets and access to technology, including other strategic assets.

The liberalization of OFDI policy alone is not enough to encourage more SMEs to go abroad to participate in internationalization and benefit from it. OFDI activities by Indian SMEs are conditional upon both government policy initiatives and firm-specific endeavours.

A number of measures, fiscal and non-fiscal, which directly impinge upon the technological capabilities of SMEs are crucial for helping them fully exploit their OFDI potential. Low levels of technological capabilities of SMEs due to resource constraints, lack of technical and trained manpower and lack of access to facilities of public-funded research institutions discourage SMEs' overseas expansion. Given that SMEs suffer from low levels of skills and have limited capability to create their own brand names, support in skills upgrading (training, management development programmes), assistance in receiving certification from international quality testing agencies and steps towards quality improvement can be helpful. Measures that will enhance SMEs' access to finance are crucial for their growth at home as well as in the global market, and should be considered.

- The provision of market information and investment opportunities in host countries is another area where the Government can support SMEs in realizing their full potential for OFDI. As government policies and the business environment may differ sharply between the home and the host country, SMEs need assistance from home and host Governments in dealing with legal matters, collecting information on overseas business opportunities and foreign market characteristics. Government policy framework supportive of international M&A could further help facilitate OFDI as a means to enhance enterprise competitiveness.

- A major constraint hindering research on internationalization of SMEs is the lack of accurate and reliable data. Hence, development of a readily available database on SMEs undertaking OFDI is an important precondition for assessing and examining comprehensively the issues faced by Indian SMEs in internationalization through OFDI.

- Certain policy measures are needed to help Indian SMEs overcome the barriers to internationalizing through OFDI, including access to finance. Facilitative measures such as institutional support and incentives could be considered. The OFDI promotion programme is another area where both the public and the private sector can work together in strengthening India's position as an emerging outward investor, with the Indian SMEs featuring prominently in the process. The need for capacity building and strengthening Indian technological capability deserves closer attention by the Government, the private sector and research institutions.

On the whole, the significant liberalization of policies by the Government and the growing competitiveness of Indian enterprises in such industries as software and pharmaceuticals have played a significant role in supporting the rapid growth of Indian OFDI in recent years. The need to secure natural resources abroad, such as oil, gas and minerals, to support the rapid growth of industrial development at home has led the Government to actively encourage both public and private enterprises to venture abroad. Against this background, the prospect for Indian OFDI, including by Indian SMEs, is promising.

References

Caves, R.E. (1971). "International Corporations: The Industrial Economics of Foreign Investment," *Economica*, 38, pp. 1-27.

Dunning, J. H. (1986). "The investment development cycle and Third World multinationals", in Khan (ed.) *Multinationals from the South*, St. Martins Press: New York, pp. 15-47.

Dunning, J. H. and Narula, R. (1996). 'The investment development path revisited: Some emerging issues', in Dunning and Narula (eds.), *Foreign Direct Investment and Governments*, London: Routledge, pp. 1-41.

ESCAP/UNCTC (1985). *Transnational Corporations From Developing Asian Economies*, Bangkok: Joint ESCAP/CTC Unit on Transnational Corporations, 1985.

Kumar, K. and M. McLeod (1981). (eds.) *Multinationals from Developing Countries*, Lexington Books: Lexington, Mass: D. C. Heath.

Lall, S. (1983). (ed.) *The New Multinationals: The Spread of Third World Enterprises*, John Wiley & Sons New York.

Lall, S. (1996). "The investment development path: Some conclusions", in Dunning and Narula (eds.), *Foreign Direct Investment and Governments*, London: Routledge, pp. 423-441.

Pradhan, J. P. (2004). "The Determinants of Outward Foreign Direct Investment: A Firm-level Analysis of Indian Manufacturing", *Oxford Development Studies*, 32(4), pp. 619-639.

Pradhan, J. P. (2005). "Outward Foreign Direct Investment from India: Recent Trends and Patterns", GIDR Working Paper, No. 153, February.

Pradhan, J. P. and Vinoj Abraham (2005). "Overseas Mergers and Acquisitions by Indian Enterprises: Patterns and Motivations", *Indian Journal of Economics*, vol. LXXXV, no. 338, pp. 365-386.

Tolentino, Paz Estrella E. (1993). *Technological Innovation and Third World Multinationals*, London and New York: Routledge.

UNCTAD (1998). *The Handbook on Foreign Direct Investment by Small and Medium-sized Enterprises: Lessons from Asia*, Sales No. E.98.II.D.4, United Nations Publications, Geneva.

Wells, L. T. Jr. (1983). *Third World Multinationals: The Rise of Foreign Investment from Developing Countries*, MIT Press: Cambridge, Mass.