

“LOOK BEFORE YOU LEAP” – MANTRA FOR SAFEGUARDING JAPANESE INTERESTS IN INDIA

By Savita Nair and Shreyas Vatsayan

India is fast emerging as a lucrative global investment hub, based on its ranking as the sixth largest and second fastest growing economy¹ in the world, and its large, young, and technically skilled labour force, which doubles as an attractive customer base.

According to the United Nations Conference on Trade and Development's World Investment Report, India was named as the fifth largest recipient of foreign direct investments in 2020.² Over seven percent of these investments are attributable to Japan, which between 2000 and 2021 became the fifth largest investor in India, accounting for inflows of over USD 35 billion cumulatively.³

Japan-India relations are expected to grow exponentially because of the increasing importance of the Asia-Pacific region in global matters, along with a parallel rise in geopolitical complexity in the area. With the COVID-19 pandemic highlighting the previously under-appreciated role of China in the global supply chain, competing regional powers – including India and Japan – have chosen to moderate this dependence on China through enhanced bilateral ties, which in turn would accelerate Japanese investments in India.

However, can the friendly ties between two sovereign nations protect private entities and investors from the risks of investing in India?

As existing Japanese investors deepen their foothold and new ones enter the promised land of India, which is a confluence of divergent interests known for its competitive federalism and issues ranging from corruption to human rights violations, they should identify and mitigate the potential risks underlying their investments. This paper explores the economic impact of a joint strategic front being formed against China, some of the common risks and threats investors may face, as well as the importance of early identification, prioritization, and mitigation of said risks.

¹ <https://economictimes.indiatimes.com/news/economy/indicators/india-to-be-the-second-fastest-growing-economy-after-china-this-year/articleshow/83953637.cms?from=mdr>

² https://unctad.org/system/files/official-document/wir2021_en.pdf

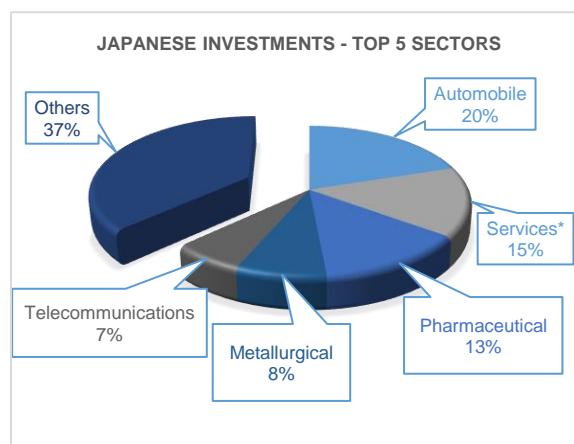
³ https://dpiit.gov.in/sites/default/files/FDI_Factsheet_March%2C21.pdf

Bilateral Thrust for Investment in India

Traditionally, over half of the investments undertaken by Japanese investors have focused on five sectors in India, as depicted in the adjacent chart. Additionally, India is also the largest recipient of Official Development Assistance⁴ (“ODA”) loans undertaken through the Japanese International Cooperation Agency⁵ (“JICA”), amounting to over USD 3 billion since 2003.⁶

Chart 1: Top Five Favoured Sectors by Japanese Investors

*Service Sector includes Including financial, banking, insurance, non-financial / business, outsourcing, research & development, courier, technology, and testing & analysis.

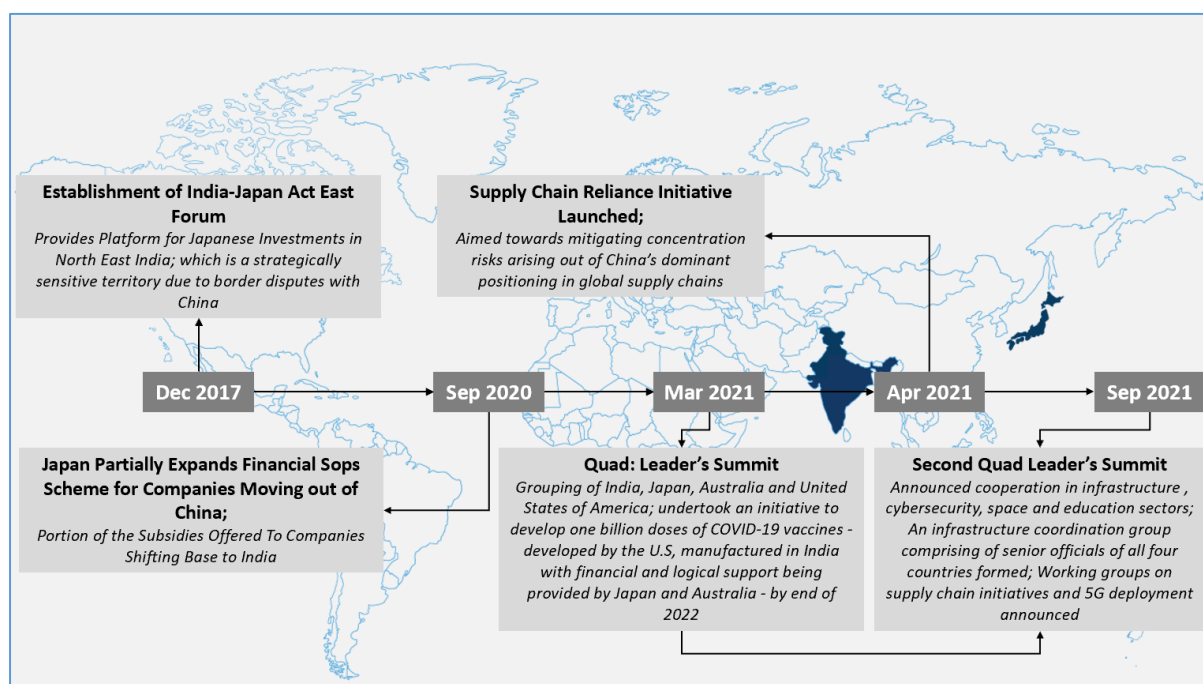


Several economic trends as well as strategic developments are expected to drive future Japanese investments in India. The ongoing economic “decoupling” by both Japan and India with its largest trading partner, China, has positioned India as a viable alternative investment destination for Japan. This decoupling, in conjunction with the strategic concerns shared by India and Japan regarding China’s increasing assertiveness in the Asia-Pacific region, has led to a spate of bilateral initiatives over the past few years. Some of the pertinent initiatives have been noted in the infographic below.

⁴ Official development assistance is defined as government aid designed to promote the economic development and welfare of developing countries.

⁵ The Japan International Cooperation Agency is a governmental agency that delivers the bulk of Official Development Assistance for the government of Japan.

⁶ <https://m.economictimes.com/news/india/india-top-recipient-of-japanese-financial-aid-since-2003-surpassing-china/articleshow/81710675.cms>



Infographic 1: Pertinent Indo-Japanese Bilateral Initiatives

The cumulative impact of such state-supported strategic and economic linkages, along with their potential *crowding in*⁷ effects, is likely to amplify India's position as an attractive investment destination for Japanese firms. In addition, India has undertaken multiple domestic programs in the recent past to further its prospects as a global investment hub - ranging from easing foreign direct investment norms to implementation of production linked incentives for strategic sectors. In a testament to the Indian administration's efforts, the country's position on the World Bank's Ease of Doing Business list improved by 79 ranks between 2014 and 2019.⁸

⁷ Crowding in occurs when higher government spending leads to an increase in private sector investment. The crowding in effects occurs because higher government spending leads to an increase in economic growth and therefore encourages firms to invest because there are now more profitable investment opportunities.

⁸ <https://timesofindia.indiatimes.com/business/india-business/india-jumps-14-places-to-63rd-in-ease-of-doing-business-rankings/articleshow/71749029.cms>

Caution: Work in Progress

While these developments promise an exciting future for Indo-Japan economic ties, India continues to be a “work-in-progress.” Unforeseen pitfalls, ranging from corporate governance issues to regulatory flux, have the potential to hamper the success rate of investments in India. Based on our team’s expertise in India, the heat map below illustrates the risks most prevalent in some of the sectors favored by Japanese investors.

Risks Factors / Sectors	Automobile	Services	Pharma	Metallurgical	Telecom
Corporate Governance Issues	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring
Legacy Corruption & Bribery Issues	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring
Accounting Irregularities & Money Laundering Concerns	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring
Existence of Shadow Investors (Politicians/ Mafia)	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring
Reliance on Political/ Bureaucratic Connections	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring
Environmental and Social Issues	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring
Land Acquisition Issues	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring	Low Risk & Likelihood of Occurring

Low Risk & Likelihood of Occurring

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Low Risk & Likelihood of Occurring

Given that these risks are likely to play out differently for different types of investors, investors must preempt threats and prepare corrective action plans. For instance, a firm undertaking greenfield investment in India should conduct strict due diligence while acquiring land in India. According to estimates by Land Conflict Watch⁹, over USD 200 billion worth of investments are threatened by land disputes in India.¹⁰ Likewise, given India’s 29 states, with some having been historically ruled by pro-business regimes and other by pro-labor parties, a market entry risk analysis should be performed to understand the differing regulations, political environment, and historical tendencies of social unrest. It is pertinent to note that Japanese government-backed institutions are doing considerable development work in the North-Eastern states of India, which have historically seen social unrest caused by separatist movements, demographic/religious conflict, and border incursions by Chinese military forces. Japanese companies involved in the execution of government-funded projects in this region should prioritize physical security risk evaluation and mitigation measures and be prepared for project delays and disruptions. Consider what occurred with the Indo-Japan annual summit that was to be hosted in Guwahati, Assam in December 2019. Prime ministers of both

⁹ Land Conflict Watch is a data-research project that maps and analyses ongoing land conflicts in India.

¹⁰ <https://economictimes.indiatimes.com/news/economy/policy/government-targets-land-disputes-that-cripple-indias-infrastructure/articleshow/80680092.cms>

countries were expected to attend as well as over 150 Japanese firms, but it was cancelled due to heavy protests against a recent law passed by the government of India.¹¹

Likewise, brownfield investors entering India through a joint venture or direct investment should undertake certain pre-transaction due diligence measures targeted together with the potential partner/investee firm. These can include assessment of the latter's corporate governance as well as financial health, identification of legacy corruption issues, hidden connections with politicians or organized crime groups, and their historical track record of dealing with labor, land, and environmental issues.

War Stories

Potential investors should also keep in mind the experiences of some of the marquee Japanese investors in India, including NTT Docomo Inc.¹² ("Docomo"), whose investment in Tata Teleservices Limited¹³ ("Tata") ended with a dispute, when the latter refused to acquire Docomo's shareholding at pre-determined prices in 2014, ostensibly in violation of an exit option provided in their investment contract.¹⁴ Tata's position was based on subsequent regulatory change by the Reserve Bank of India¹⁵ ("RBI"), which prohibited sale of equity shares at predetermined prices.¹⁶ Despite the Tata's subsequently acquiescing to Docomo's position, the settlement process was hampered when RBI filed a petition opposing the settlement in the Delhi High Court. While the RBI's plea was eventually rejected, the dispute lasted over three years and across courts in India, the United Kingdom, and the United States. This case highlights the need for Japanese firms to regularly monitor regulatory risks emanating from existing and/or new policies.

Japanese firms have also been victims of labor strikes, with recent events involving Honda Motor Company's Indian subsidiary in 2019 and Toyota Motor Corporation's¹⁷ joint venture in 2021. Often facilitated by labor-friendly regulations, such issues are further complicated by the implicit links between labor unions and local political elements, organized crime, and other antisocial elements. For example, the strike against Toyota Motor Corporation's joint venture, which went on for more than five months, reportedly had the support of a former chief minister of Karnataka.

Such operational and reputational risks are not limited to corporate activities. Bilateral, as well as developmental undertakings initiated with the support of central and state governments, have also been known to come under fire from local populations, environmentalists, and non-governmental organizations (NGOs). These challenges come with the potential of being or becoming politically

¹¹ <https://timesofindia.indiatimes.com/city/guwahati/anti-kaa-protests-are-hampering-economic-development-chandra-mohan-patowary/articleshow/73198684.cms>

¹² NTT Docomo Inc. is a mobile phone operator in Japan.

¹³ Tata Tele Business Services Limited, formally known as Tata Tele Services Limited, is an Indian broadband and telecommunications service provider based in Mumbai.

¹⁴ https://www.business-standard.com/article/companies/tata-docomo-dispute-what-s-it-about-and-where-things-stand-today-116110400673_1.html

¹⁵ The Reserve Bank of India is India's central bank and regulatory body for the banking industry as well as foreign exchange management.

¹⁶ <https://www.thehindubusinessline.com/info-tech/rbi-to-court-fema-rules-prohibit-tatas-from-paying-docomo/article9405097.ece>

¹⁷ Toyota Motor Corporation is a Japanese multinational automotive manufacturer headquartered in Toyota City, Aichi, Japan.

charged an ever-present threat. A case in point would be the 2017-launched Ahmedabad-Mumbai high-speed rail project, facilitated by a memorandum of understanding between JICA and the Union Railway Ministry of India. Despite being supported by the highest levels of both governments; the project has suffered significant delays owing to environmental protests and land acquisition issues. In December 2018, farmers, and activists from the western Indian state of Gujarat, allegedly perturbed by violation of land acquisition norms, met with JICA representatives to voice their concerns. In addition to filing over 200 legal petitions, the protestors also indicated their intention to take legal action in Japanese courts and with the Japanese government.¹⁸

Similarly, environmental protests in Mumbai, Maharashtra in late 2019 against the decision to cut down 2,700 trees in order to construct a car shed for a bullet train project led to JICA being the target of social and political activism, due to its ODA support for the project.¹⁹ The construction on the car shed was subsequently stalled after an opposition political faction came to power in Maharashtra.²⁰ Prolonged delays in this project could potentially affect the operations of the involved Japanese firms, such as IHI Infrastructure Systems Co. Ltd.²¹, which, as part of a consortium with Larsen & Toubro Limited²², will be constructing bridges for the project.

Risk Management: Changing Goalposts

Spurred by the economic impetus of strategic ties between the two central governments, Japanese investors and companies are increasingly expected to flock to India - either as corporate investors or service providers supporting the Japanese government's developmental activities in India. Japanese private equity fund Unison Capital's planned foray into India with half a billion dollars furthers the belief that India continues to be a preferred investment destination.²³ However, with its complicated semi-federal structure consisting of 29 states, a constantly evolving regulatory framework, and its unique blend of different cultural, ethnic, and linguistic groups, investing in India calls for a cautionary approach. Further, the onset of COVID-19 marks the beginning of an increasingly disruptive world, with a rapidly changing climate giving power to environmental groups as well as sovereign states leading the charge of hidden agendas and masked actions, often under the guise of innocent economic activities.

Lately, we have seen instances of companies confronted with opposition to their operations by purported environmental activists and NGOs. Upon investigation, it was discovered that these were

¹⁸ <https://www.livemint.com/Politics/a1Jx737NYIIEjfkMNf7F9H/Will-take-our-fight-to-Japan-say-Gujarat-farmers-opposing-b.html>

¹⁹ <https://www.hindustantimes.com/mumbai/tree-cutting-at-aarey-colony-japanese-funding-agency-won-t-intervene/story-ovXiHKOLQZIEVAQgZhyq2H.html>

²⁰ <https://www.indiatoday.in/india/story/mumbai-metro-aarey-car-shed-green-belt-maharashtra-climate-floods-1641301-2020-01-29> ; <https://timesofindia.indiatimes.com/city/mumbai/mumbai-aarey-metro-shed-site-being-cleared-closed/articleshow/78137873.cms>

²¹ IHI Infrastructure Systems Co. Ltd. is a Japanese firm involved in design, fabrication, construction, assessment, repair and maintenance of bridges, gates, and various other steel structures.

²² Larsen & Toubro Ltd is an Indian multinational conglomerate, with business interests in engineering, construction, manufacturing, technology, and financial services, headquartered in Mumbai.

²³ <https://asia.nikkei.com/Business/Business-trends/Japan-s-Unison-Capital-making-a-500m-foray-into-India>

hidden actions of competitors and even sovereign hostile states. The rise of these new challenges underscores the ever-shifting goalposts of the risk management function.

CONCLUSION

Based on India's political, socio-economic, and regulatory environment, global investors looking towards India must undertake holistic risk assessment and continually monitor emerging threats from various quadrants, as a human rights or corruption scandal in India may have reputational ramifications that adversely impact their worldwide operations. However, with the assistance of experts who can conduct proper due diligence and offer advice on other precautionary steps to take, foreign investors can benefit from the unique growth opportunities in India.

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