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Navigating Disinvestment in India: Insights from a Successful Acquisition

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Deepak SINHMAR

Disinvestment is the process by which a government sells a portion or all of its stake in a state-owned enterprise to private entities or investors. Governments pursue disinvestment for various reasons, including to enhance operational efficiency, provide a more equitable environment for private businesses, increase competition in markets, alleviate financial burdens and enable a greater focus on essential governmental duties. In fact, all major economies worldwide have, at different points, embraced disinvestment in one form or another. Based on our recent experience of advising a Japanese company on a strategic disinvestment in India, this write-up examines India's divestment process.

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1. HISTORY OF INDIA'S PUBLIC SECTOR ENTERPRISES

Following its independence in 1947, India faced severe economic and social challenges, including illiteracy, unemployment, income disparity and underdeveloped infrastructure and technology. To stimulate industrial growth, the Government of India ("**Gol**"), at both the Union and State levels, established several Public Sector Enterprises ("**PSEs**"). However, not all PSEs could achieve their intended objectives. In fact, many incurred losses and faced difficulties due to lack of innovation, insufficient funding, inefficient management, compliance shortcomings, increased competition, et al. Consequently, in 1991, the Gol introduced a series of initiatives to revitalize the economy. These reforms included a policy of economic liberalization, removal of industrial licensing requirements, reduction of PSE monopolies, opening to foreign direct investment and the commencement of PSE disinvestment. As a result, between 1991 and 2021, the Gol successfully completed the disinvestment of several notable PSEs, including BALCO, Hindustan Zinc Limited, Indian Petrochemicals Corporation Limited, Maruti Udyog Limited (now Maruti Suzuki India Limited), and VSNL.

2. REGULATORY FRAMEWORK

- 2.1 In 2021, with an objective to enhance the efficiency, competitiveness, and profitability of Indian PSEs and to streamline the disinvestment process, the Gol unveiled "New Public Sector Enterprise Policy" (the "**Policy**"). Further, the Department of Investment and Public Asset Management ("**DIPAM**"), operating under the Ministry of Finance, Gol, was given responsibility for implementing the Policy.

- 2.2 Pursuant to its powers, DIPAM has issued several office memoranda which, when read in conjunction with the Policy, provide comprehensive guidance on India's disinvestment process.
- 2.3 Based on size, financial performance and operational autonomy, the Indian PSEs can be categorized into: (a) Maharatna (first-tier PSEs), (b) Navratna (second-tier PSEs), (c) Miniratna (third-tier PSEs), and (d) Non-ratna (fourth-tier PSEs). Their levels of autonomy and decision-making authority also vary significantly across these tiers, with Maharatnas enjoying the most independence and Non-ratnas the least.
- 2.4 The Policy further categorizes PSEs into (a) Strategic and (b) Non-Strategic sectors. Strategic sectors are identified based on the following criteria:
 - (i) National Security: PSEs that operate into atomic energy, space and defense.
 - (ii) Critical Infrastructure: PSEs that operate into transport and telecommunication.
 - (iii) Energy Security: PSEs that operate into power, petroleum, coal and other minerals.
 - (iv) Financial Security: PSEs that operate into banking, insurance and financial services.
- 2.5 The Policy outlines broader principles for PSE disinvestment, depending on their sector of operation:
 - (a) Strategic Sector: With respect to PSEs in strategic sectors discussed above, the GoI will gradually reduce its ownership while maintaining a minimum level of control at the holding company level through methods such as Initial Public Offerings (IPOs), Further Public Offerings (FPOs), Issue of Shares, Offer for Sale and Buyback of Shares.
 - (b) Non-Strategic Sector: For PSEs in non-strategic sectors, the GoI will consider either complete privatization (i.e., transfer of full ownership along with management control) or outright closure.

3. GUIDELINES FOR DISINVESTMENT

In accordance with the Policy and office memoranda, the following outlines the general guidelines for the disinvestment of PSEs in India:

- 3.1 With effect from June 1, 2022, the boards of parent or holding PSEs have been empowered to recommend their subsidiaries or units for disinvestment or closure. Prior to that, the Department of Public Enterprises ("**DPE**") was responsible for identifying such entities.
- 3.2 A disinvestment proposal from a parent PSE's board typically goes through respective Administrative Ministry ("**AM**") to DIPAM for in-principle approval. DIPAM then consults the proposal with an "Alternative Mechanism" (a high level decision making body comprising representatives from the Ministry of Finance, the AM and the Minister of Road Transport and Highways) to secure the in-principle approval. It is relevant to note that for disinvestment proposals approved before June 1, 2022, DIPAM continues to manage the disinvestment processes.
- 3.3 Following in-principle approval, the parent PSE's board, in consultation with the Inter-Ministerial Group ("**IMG**") and Alternative Mechanism, appoints professional advisors such as a Transaction Advisor ("**TA**"), Legal Advisor ("**LA**"), and Asset Valuers ("**AV**"). TA and LA assist in finalizing the transaction structure, establishing a transparent bidding process, setting due diligence process, performing security, background checks on potential bidders, etc. The AV assists in arriving at the reserve price.

- 3.4 In consultation with IMG and AM, the key definitive agreements, such as the Share Purchase Agreement (“SPA”), Shareholders’ Agreement etc., are drafted and finalized, incorporating necessary feedback from bidders. The highest bidder exceeding the reserve price is awarded the bid.

4. PROCEDURE FOR DISINVESTMENT

Based on the broader guidelines outlined above, PSEs or DIPAM (as the case may be) carry out the disinvestment process. Our law firm had the privilege of advising a Japanese company in successfully acquiring an Indian PSE where DIPAM, in consultation with the Alternative Mechanism and IMG, managed the disinvestment process. The following outlines the step-by-step procedure adopted during this particular transaction:

- 4.1 **Issuance of Preliminary Information Memorandum (“PIM”):** The TA issues a PIM document, inviting expressions of interest from interested bidders. The PIM provides important information about the target PSE, including: (a) company overview, capital structure, board of directors, senior management, existing operations, licenses, financial position, liabilities, value proposition and industry overview; (b) structure of the proposed transaction; (c) key timelines and schedules; (d) eligibility conditions for bidders (financial and technical); (e) disqualifications; (f) instructions and formats for bid submission; and (g) the overall process for the proposed transaction.
- 4.2 **Expression of Interest (“EOI”):** Interested bidders are advised to thoroughly review the PIM document and seek necessary clarifications before submitting their EOIs along with supporting documents in the prescribed format.
- 4.3 **Shortlisting of Bidders:** An evaluation team (comprising the TA, LA and representatives from DIPAM, IMG and the PSE) assesses the EOIs submitted by prospective bidders and eligible bidders are then shortlisted.
- 4.4 **Request for Proposal (“RFP”):** Shortlisted bidders are subsequently provided with an RFP document, which contains the detailed information required to complete the transaction.
- 4.5 **Due Diligence:** Subject to the execution of confidentiality agreements, shortlisted bidders are granted access to a data room to conduct due diligence on the target PSE. Shortlisted bidders are permitted to submit questions, seek clarifications and address any concerns related to the data.
- 4.6 **Security Clearance:** Shortlisted bidders are required to obtain security clearance in the manner and format provided with the RFP. The security clearance application necessitates the submission of detailed information, including corporate details, shareholding structure, declarations related to presence or operations in countries sharing land borders with India (compliance with Press Note 3 of 2020) and information related to significant beneficial owners, company directors, etc. (such as date of birth, place of residence, national ID, including details of any criminal cases pending against the shortlisted bidder, its promoters, or directors).
- 4.7 **Issuance of Transaction Documents:** Once the security clearance process is complete, shortlisted bidders receive draft transaction documents, such as the SPA, for their review and comments. These drafts are typically pre-approved by Alternate Mechanism and other relevant authorities; thus, bidders should expect limited scope for revision.

- 4.8 **Submission of Financial and Non-financial Bids:** After due diligence and review of transaction documents, shortlisted bidders are required to submit their (a) Non-financial and (b) Financial bids separately in sealed envelopes, following the prescribed format. The non-financial bid must be accompanied by a bid security in the form of a bank guarantee issued by a bank listed in the Second Schedule to the RBI Act, 1934. The bid security amount is determined by the Gol and is refundable. If a bank guarantee is provided by a foreign bank outside India, it must be confirmed by a nationalized bank in India.
- 4.9 **Opening of Non-Financial Bid:** Following bid submission, shortlisted bidders are invited to a bid opening ceremony conducted by DIPAM, IMG and relevant PSE officials in the presence of the shortlisted bidders. Each participant is required to authenticate sealed bid covers by signing them, thereafter the non-financial bid envelopes are opened. The LA and TA confirm that the non-financial bids are in order. DIPAM may, at its discretion, request additional information from bidders if any documents are incomplete or unclear. Shortlisted bidders who successfully pass the scrutiny of their non-financial bid and security clearance are declared as the **"Technically Qualified Bidders"**.
- 4.10 **Opening of the Financial Bid:** Technically Qualified Bidders are invited to a meeting for the authentication and opening of their Financial Bids in the presence of officials from IMG, DIPAM, PSE, TA, and LA. The bidder with the highest financial bid is declared H-1 or **"Confirmed Selected Bidder"** and is issued a Letter of Award (**"LOA"**). Here it is relevant to note that the H-1 bid should be higher than the reserve price approved by the Gol; otherwise, the disinvestment deal may be called off.
- 4.11 **LOA and Payment Security:** Within a prescribed period, the Confirmed Selected Bidder is required to return a duly signed copy of the Letter of Award along with a refundable payment security. The payment security, usually 10% of the purchase consideration (the highest financial bid), must be in the form of a bank guarantee issued by a scheduled Indian bank. If a bank guarantee is provided by a foreign bank outside India, it must be confirmed by a nationalized bank in India.
- 4.12 **Execution of Transaction Documents:** Within the stipulated timeframe, the Confirmed Selected Bidder and the concerned parent PSE must execute the agreed-upon transaction documents.
- 4.13 **Transfer of Shares and Closing of the Transaction:** In accordance with the transaction documents, parties must satisfy all closing conditions. On the scheduled closing date, ownership of shares, along with management control, is transferred to the Confirmed Selected Bidder. Current regulations mandate that physical shares be converted into dematerialized form and both seller and buyer must possess a demat account.
- 4.14 **Post-Closing Work:** PSE disinvestments often include specific covenants, such as (a) restrictions on share transfers in the form of lock-ins, (b) restrictions on asset disposal, (c) continuity of the business on going concern basis, and (d) limitations on employee removal for a certain period. The Confirmed Selected Bidder is obligated to comply with these post-closing obligations as per the transaction documents.

5. KEY TAKEAWAYS

India's PSE disinvestment process differs significantly from a standard private sector mergers and acquisitions. It involves a unique set of challenges, including unpredictable timelines and complex decision-making processes stemming from the involvement of multiple government stakeholders.

Government officials often prioritize established administrative practices and protocols over market driven best practices.

Bidders may encounter difficulties in gathering necessary information, as PSE employees are often hesitant to share data. Arranging interviews with PSE officials, or site visits can become protracted due to the hierarchical organizational structures. For foreign bidders, these complexities are often compounded by differences in work cultures and a lack of familiarity with foreign regulatory standards on the part of PSEs and their advisors, frequently leading to repetitive information requests.

The disinvestment process in India is also susceptible to external factors, such as political changes at the Union and State levels, legacy matters related to the PSE, and labor disputes. Indian PSE employees still prefer the stability of public sector over private sector employment. This transition can become a point of contention, potentially leading to organized strikes or court cases challenging the disinvestment process, thus causing significant delays to the transaction timeline.

Successfully navigating disinvestment deals in India, therefore, requires more than technical skills; it calls for extensive local knowledge, patience, and practical experience. This is exemplified by our law firm's recent advisory role for a Japanese client in the 28-month-long disinvestment of an Indian PSE. Throughout this period, the transaction weathered uncertainties related to a general election, labor strikes, security concerns, court cases, and changes in government officials. Despite these hurdles, our team remained focused on supporting our client's long-term objectives by interpreting government policies, anticipating regulatory changes, facilitating crucial negotiations and aligning the expectations of diverse stakeholders.

Despite the inherent complexities, PSE divestments in India have historically proven to be lucrative deals for the successful bidders, justifying the lengthy and detailed process. The involvement of experienced advisors is key to seamlessly navigating these challenges. This landmark transaction, which marked the first full acquisition of an Indian PSE by a foreign company in a single deal, concluded successfully. We are optimistic that this achievement establishes a clearer path for future acquisitions by international investors. We take great pride in our contribution to this significant milestone and our client's success.

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