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Acquisition financing in India

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Although the Indian deals market has been abuzz with large acquisitions, both national and cross-border, what is notable is the growing trend among Indian corporates of acquiring companies far larger than themselves in offshore jurisdictions. The acquisition of Corus, a company with a capacity of 18.3 million tonnes a year, by Tata Steel, whose capacity at the time of acquisition was a mere 5.93 million tonnes a year, for $12.9 billion in January 2007 is a case in point. Also notable is the acquisition of Novellis by Hindalco Industries for $6 billion in May 2007. While Indian corporates are aggressively expanding their horizons, their counterparts offshore are similarly targeting and acquiring or setting up operations within India. Vodafone's long-drawn-out acquisition of a 67 per cent stake in Hutchison Essar at $11.1 billion was one of the largest foreign investment transaction in India to date. While availability of funds is a favourable driver for investments, mergers and acquisitions, it has been the structuring options devised for Indian acquirers which have enabled them to make acquisitions offshore as, unlike their offshore counterparts, Indian corporates are faced with hurdles in the form of domestic legal and regulatory restrictions when embarking on any acquisition strategy.

Issues generally arise depending on the nature of the company being acquired, as well as whether the acquisition and the funding are on a cross-border basis or on a purely onshore basis. In addition, there are restrictions depending on the type of financier, as well as the options available to secure the financier's interests, whether by way of collateral or debt servicing.

Indian regulations impose restrictions on the ability of banks in India in relation to acquisition financing, prohibiting them from lending to a borrower, irrespective of whether the borrower is located offshore or onshore, or whether the funds are to be used to purchase shares of an Indian

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company. However, there is an exemption as regards loans for acquisition of shares of an onshore infrastructure company upon the fulfilment of certain conditions. In addition, funding by Indian banks to Indian corporates, up to stipulated limits, is permitted for the acquisition of offshore companies.

The degree of exposure to capital markets of a bank in India is also subject to stringent limits. While offshore banks (which, for the purposes of exposure limits, include foreign branches of Indian banks) are not subject to most of these restrictions; under Indian exchange control laws, foreign currency loans, including the proceeds of foreign currency convertible bonds and external commercial borrowings (ECBs) cannot be availed of for the purposes of onshore acquisitions. Although ECBs could be utilised for the acquisition of offshore companies, the various restrictions, including the all-in-cost ceilings and the cap on interest, make it difficult for many Indian companies to resort to them directly.

Due to these restrictions, financing offshore acquisitions by an Indian company are structured such that the borrower is an offshore subsidiary and/or a special purpose vehicle set up by the Indian company. Offshore structures can be used by an Indian company for onshore acquisitions as well; however, in such cases certain issues relating to round-tripping arise.

Debt servicing is an additional issue to be dealt with while structuring an acquisition. One option is the payment of dividends by the Indian target company. However, this is not a tax-efficient way to upstream cash to the borrower to enable it to service the funds raised, as under Indian law a dividend distribution tax of approximately 17 per cent is payable by the Indian target company. In the event that the transactions are structured as a two-tier holding structure for the purposes of acquiring the Indian target company, the tax is payable twice. In addition, this does not guarantee a steady stream of funds, as while the payment of dividends is correlated to the profits made by the Indian target company, it is also entirely at the discretion of board of directors of the Indian target company. The utilisation of any offshore earnings of the borrower or the Indian target company could also be considered. Buy-back of shares by the Indian target company is a structuring possibility. However, under Indian law a company faces limitations on the percentage of its shares it can buy back. The current limits are 10 per cent of its shares with board approval and 25 per cent of its shares with prior shareholder approval. There are additional qualitative restrictions, including that only one buy-back is permissible within any 12-month period. Furthermore, each buy-back is subject to a solvency test, including certification of solvency from the target's auditors and a declaration of solvency by the board of directors of the target. In addition, depending on the jurisdiction of the borrower, the tax incidence would have to be evaluated to ascertain whether there would be any exemption from the Indian withholding tax on the capital gains arising from a share buy-back. The borrower's choice of jurisdiction is generally driven by taking into consideration the incidence and rate of withholding tax on interest and tax on capital gains.

As the exposure of Indian banks to the capital markets is subject to prescribed ceilings, Indian companies and sponsors resort to borrowing from non-banking financial companies (NBFCs). As the nomenclature indicates, these are quasi-banks that cannot take on-demand deposits or issue cheque books. Unlike banks, NBFCs have no limit on capital market exposure. Therefore, they can take security in the form of pledge of shares of Indian companies without having to worry about hitting capital market exposure limits. However, if the NBFC has an asset size of Rs1 billion (approximately $25 million), it is classified as a systematically important NBFC and must maintain a capital adequacy ratio of 10 per cent. In addition, systematically important NBFCs have counterparty exposure norms (15 per cent for a single borrower and 25 per cent for borrowers belonging to the same group). Given the capital adequacy and single and group borrower restrictions, most systematically important NBFCs do not have the balance-sheet size to undertake big-ticket transactions.

Due to the nature of activity conducted by hedge funds, they are categorised and must be registered as NBFCs in India. Hedge funds are yet to begin their entire range of activities in India (and those that have set up shop in India are primarily facilitating offshore investments into India), due to the restrictions stipulated under the NBFC regulations, pursuant to which, as registered NBFCs, they must maintain prescribed capital adequacy ratios (which would effectively restrict the quantum of leverage) and are subject to counterparty lending exposure limits.

Liberalisation has resulted in most sectors of operations of Indian companies being made open to foreign direct investment, thereby making it easier for Indian companies to raise finance through offshore investments, the only limitation being that the proceeds of the foreign investments raised cannot be utilised to acquire shares of existing Indian companies. Further, Indian subsidiaries of foreign companies are not permitted to raise funds onshore from any source for the purposes of making acquisitions in India.

Lenders invariably seek to secure their interests by insisting on collateral. For an Indian borrower to grant security over certain types of asset, including those located in India in favour of an offshore lender, prior Reserve Bank of India (RBI) approval is necessary. However, if the loan is granted by an offshore lender (which is a regulated bank) to a borrower located outside India, prior RBI approval is not required if the Indian parent pledges the shares in the borrower in favour of such lender. While this exception exists, it is a moot point whether the same could be used in the case of a consortium lending where the consortium includes non-bank entities in the lender group and/or if the funds are raised by the issuance of notes.

In most cases, guarantees are also obtained from the borrower and/or the onshore corporate promoters or associates of such promoters. No RBI approval is required for the giving of such guarantee if certain conditions are fulfilled. These include the financial commitment (whether in the form of equity, shareholder loan or guarantee) of the onshore company to its offshore subsidiaries or joint ventures not exceeding 400 per cent of its net worth, as indicated in its latest audited financial statements.

Acquisitions in the case of listed companies must also comply with various other regulations, including those under the Securities and Exchange Board of India (Substantial Acquisition of Shares & Takeovers) Regulations 1997 (known as the Takeover Code) and the Securities and Exchange Board of India (Buy-Back of Securities) Regulations 1998. Under the Takeover Code, acquisitions of or in excess of 15 per cent of shares, or acquisitions of control in any manner, require prior public announcements and open offers to be made by the acquirers. However, it is possible to acquire stakes in a listed company without making a public announcement by resorting to the provisions of the Companies Act 1956, under which schemes of merger, demerger, amalgamation and arrangement can be effectuated pursuant to the prior approval of the courts.

The Competition Act 2002, as amended by the Competition (Amendment) Act 2007, will, on being fully notified, throw a spanner in the booming mergers and acquisitions arena in India, as well as for those mergers and acquisitions taking place outside India which have a direct or indirect connection to competition within India. The thresholds prescribed for mandatory notification to the Competition Commission of India are relatively low for certain sectors, particularly when compared with offshore jurisdictions, and purely offshore acquisitions are also targeted. The thresholds prescribed for mandatory notification relate to the combined assets of the acquirer and the target in India, or the combined assets of the parties in or outside India. Once notified, the commission has 210 days to conduct inquiries and issue an order regarding whether, in its opinion, the proposed acquisition or merger is likely to cause an appreciable adverse impact on competition within India. If, any person is aggrieved by the order passed by the commission, an appeal can be filed within 60 days before the Competition Appellate Authority; thereafter, a further appeal can be filed within a period of 60 days before the Supreme Court of India. The only

acquisitions exempted from the examination by the commission and which need only be intimated to the commission are those resulting pursuant to any covenant of a loan agreement or investment agreement entered into by public financial institutions, foreign institutional investors, banks and venture capital funds. Further, there is no guidance on how conflicts between the Competition Act and other laws and regulations, including the Takeover Code, should be resolved.

Obtaining any type of regulatory approval is an impediment to an acquisition transaction and - given the uncertain timeframes involved and the possibility of refusal of approval, which would lead to the acquisition falling through - the challenge is always to structure a transaction in such a manner that the fewest regulatory approvals are required. Originality knows no bounds and innovative structures have evolved in the Indian market over the past few years.

A typical leveraged buy-out in India contemplates that the assets of the target company be used as security for the loan raised by the acquirer for the purposes of acquiring the target. The existing RBI guidelines prohibit Indian banks from providing loans against the security of shares for the purposes of acquiring companies in India, and the Companies Act 1956 prohibits the provision of financial assistance by any public company (whether listed or unlisted) to any person for the purposes of purchasing the shares of that public company. These provisions render the execution of leveraged buy-outs in India relatively difficult in regard to the execution of leveraged buy-outs in offshore jurisdictions by Indian corporates.

A commonly used structure where the acquirer is offshore and the target is within India comprises setting up a special purpose vehicle to hold the equity in the acquirer, with the promoter holding the shares in that special purpose vehicle. The special purpose vehicle raises funds for acquisition of the Indian target company by providing the shares of the acquirer as collateral to the offshore lender.

In synthetic debt structures where it is not possible to secure cross-border lending without RBI approval, an offshore company usually raises the money and invests in the Indian company which requires the funds to acquire the Indian target. As security cannot be created on a cross-border basis without RBI approval, security is usually created over the offshore company by its promoters in favour of the offshore lenders, thereby indirectly creating security on the Indian target company.

An interesting structure is where a split hedge is used between two associated entities where the onshore entity is the entity lending to the borrower and security is granted in favour of the onshore entity. A back-to-back guarantee is granted by the offshore parent of the onshore entity on behalf of the borrower in relation to the loan. The credit risk is then transferred by the offshore entity to offshore investors by issuance of notes which fund the guarantee granted by the offshore parent. The manner in which the deal is structured is such that, upon an event of default, the entire structure unwinds and the offshore investors are entitled to the security granted in relation to the loan.

An overview of the Indian legal and regulatory scenario indicates that the current policies give impetus to offshore acquisitions compared to onshore acquisitions. However, despite the strict regulatory environment, Indian corporates have more than created a stir in the global acquisition arena.