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## Could You Leverage Your Indian Buyout?

India has emerged as one of the strongest markets for Mergers and Acquisitions (M&A). In 2018 and 2019, the value of M&A activity was US\$ 129 billion and US\$ 64 billion, respectively<sup>1</sup>. During 2019, Private Equity (PE) investments witnessed an increase of 13.8 percent in terms of value<sup>2</sup>. Across the globe, the trend of using debt to fund acquisitions has increased.

This article discusses Leveraged Buyouts (LBOs) in case of acquisition of Indian company shares by a non-resident entity from an Indian tax and regulatory context. LBO means acquisition of a business with a substantial use of debt for structuring the transaction. LBOs provide increased Internal Rate of Return (IRR) to the buyer by leveraging the target's assets. They could also provide tax efficiency, as interest payouts are generally tax deductible compared to dividend.

Leveraged Buyouts structures



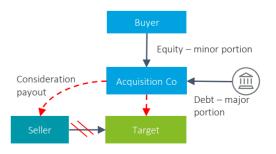
In case of acquisition of shares of Indian entity (i.e., inbound LBO), transactions are largely equity oriented. Debt-financed deals are handful due to various tax and regulatory challenges prevailing in India. Below are some of the prevalent laws and restrictions:

- Domestic banks are prohibited from providing loans for acquiring shares of Indian companies in most sectors
- Under External Commercial Borrowings (ECB) regulations, Indian entities cannot take loans from non-residents for acquiring capital instruments
- Existence of Foreign Direct Investment (FDI) caps across many sectors in India, making it unattractive for foreign investor willing to acquire 100 percent of Indian target
- Compliance with thin capitalisation provisions, which restricts tax deductibility of interest payments beyond prescribed limit

#### To overcome the above-mentioned hurdles, common structures adopted for executing inbound LBOs are below.

#### Foreign holding company structure

Buyer sets up a foreign holding company (referred to as Acquisition Co) and finances it with equity. Acquisition Co raises debt from foreign banks or financial institutions. Proceeds of debt and equity are used to acquire shares or securities of Indian target. Cash flow generated by acquired target is up streamed in the form of interest, royalty, dividend, etc., to discharge the debt obligation of Acquisition Co.



<sup>1</sup>Source: <u>https://www.ibef.org/</u>\$48 million till September 2019; proportionately converted for 2019 <sup>2</sup>Source: Annual report of Vccedge for 2019

#### Points for consideration

• Choice of jurisdiction while setting up Acquisition Co – Jurisdiction that can attract debt, and has good treaty with India to service debt and facilitate future exit would be preferred. Countries such as Mauritius, Singapore are usually considered



Lien on asset – Wherever target shares are provided as pledge and in case buyer is not able to service the loan, then a collateral will be released in favour of the lender. India allows shares of the Indian company to be pledged subject to conditions.

#### Indian company structure

Buyer sets up a domestic holding company or uses an existing Indian group company (referred to as Acquisition Co) and finances it with equity. Buyer raises debt in foreign country. Debt is pushed down to Acquisition Co in form of Non-convertible Debentures (NCDs). Proceeds of debt are used to acquire shares of Indian targets. Cash flow generated by acquired target is up streamed in the form of interest, royalty, dividend, etc., to discharge the debt obligation of Acquisition Co.



#### Points for consideration

- Lien on asset Prior approval of government may be required where target sector is regulated by government
- **Debt push down** Based on Acquisition Co's ability to repay and thin capitalisation rules in India and overseas, amount of debt that can be pushed down would have to be determined
- **Compliances** For the Acquisition Co, compliance with Non-Banking Financial Companies (NBFC)/Core Investment Companies (CIC) regulations have to be evaluated
- **Tax attributes** There would be withholding taxes on interest payouts (depending on country of residence of the lender). The withholding could reduce the IRR.

#### Asset buyout structure

Buyer sets up a domestic holding company (referred to as Acquisition Co) and finances it with equity. Acquisition Co raises debt to acquire operating assets of the target. Debt is secured against such operating assets. Proceeds of debt are used to acquire operations of target. Debt is repaid using cash flow generated by the acquired business.

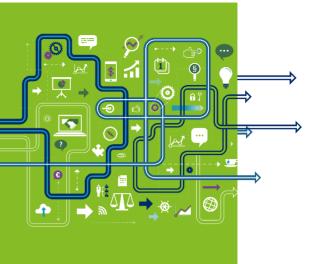


#### Points for consideration

- Lien on asset It will be generally available as this would be a domestic transaction
- Stamp duty implications Asset buyout structure could result in higher stamp duty depending on the state in which the seller is located and whether any immovable property is being transferred
  Speed of acquisition would be fastest in this case

### Way forward

Of late, the government has made many changes to promote foreign investment in India. It has eased the FDI caps and allowed automatic approval up to 100 percent in several sectors such as coal mining, contract manufacturing, etc. Debt regulations have been relaxed. Dividend Distribution Tax (DDT) has been abolished. Rate of return on equity capital of foreign investors have increased due to abolition of DDT. However many countries, including India, have signed a Multi-Lateral Instrument (MLI), which restricts the tax benefits investors can claim. Similarly, General Anti Avoidance Rules (GAAR) also have been implemented under Indian tax law. The acquisition structure needs to have strong commercial rationale and should not be set up only for the purpose of claiming tax benefits.



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