PRIVATE EQUITY (TRANSACTIONS)

India

LEXOLOGY
Getting The Deal Through

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Private Equity (Transactions)

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Quick reference guide enabling side-by-side comparison of local insights, including into types of private equity transaction; corporate governance, disclosure and timing considerations; dissenting shareholder rights; key purchase agreement provisions; participation of target company management; tax; financing; shareholders' agreements; exit strategies (including IPOs); target sectors; cross-border considerations; club/group deals; and key recent developments.

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TRANSACTION FORMALITIES, RULES AND PRACTICAL CONSIDERATIONS

Types of private equity transactions

What different types of private equity transactions occur in your jurisdiction? What structures are commonly used in private equity investments and acquisitions?

Private equity (PE) transactions in India broadly comprise early stage investments, including:

- seed capital
- angel investments;
- venture capital;
- growth capital (including expansion capital);
- late-stage investments;
- private investments in public equity;
- buyouts; and
- turnaround capital.

Traditionally, early stage transactions in India fell under the umbrella of venture capital investments. However, this trend has changed in the past few years, with many traditional venture capital investments rivalling PE investments in terms of deal size and valuation.

Most PE investments in India occur in closely held unlisted companies. PE investments in listed companies are less frequent for a number of reasons, including:

- the lack of quality assets for PE investors to commit substantial funds;
- the inability of PE investors to complete going-private deals on account of the inefficiencies of India's delisting regulations and the limited options available to complete minority squeeze-outs;
- the limited extent to which PE investors may seek enforcement of shareholder rights customarily sought in such transactions; and
- the inability of PE investors to obtain acquisition financing (except in limited circumstances).

India has historically been a market for minority investments by PE firms, including global buyout firms. This trend has changed, as most of the major buyout firms active in India are looking for control transactions.

Most PE investments are structured as primary or secondary investments, or a combination of both. PE investors typically invest in equity or preferred capital, or a combination of both. Indian exchange control regulations applicable to foreign direct investment (FDI) typically recognise only equity shares, compulsorily convertible shares, compulsorily convertible debentures, and warrants exercisable for the aforesaid instruments as permitted capital instruments. All other instruments that are optionally or not convertible into equity or equity-like instruments are considered debt under the Indian exchange control regulations, and are governed by separate regulations.

Indian regulators have permitted certain registered start-ups to raise funds from foreign investors through convertible notes. Convertible notes are initially debt instruments that are repayable at the option of the holder or convertible into equity shares within a period of five years from their issuance. The regulations specify a minimum investment amount and also permit the transferability of such instruments in accordance with Indian exchange control regulations.

In addition, Indian exchange control regulations prohibit foreign investors from seeking guaranteed returns on equity instruments in exits. Consequently, PE investors are, at times, limiting their equity exposure in Indian companies and ensuring downside protection by investing through a combination of equity or preferred capital and non-convertible debentures (NCDs). Investments in listed and unlisted NCDs may be secured by Indian assets in favour of an Indian resident trustee. PE investors are able to structure their investments in a manner that maximises capital protection by stipulating a minimum return on the NCDs, while also participating in the risks and rewards of the portfolio company as a shareholder.

An increasing trend is for foreign strategic players with surplus capital to invest in Indian assets. Several strategic players have established proprietary PE arms and have led notable transactions in recent years. Similarly, several government-sponsored foreign pension funds are following suit with sovereign funds, and increasing their exposure in India. Other trends include several large PE investors participating in consortium or club deals, and participating in the sale of Indian assets through an auction process. In both cases, the primary considerations are the lack of opportunities to invest in quality assets and the inflated valuations of certain assets. This has increased competition among PE investors and has also led to several mid-sized PE investors forming consortia to compete with larger PE investors on large transactions.

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Corporate governance rules

What are the implications of corporate governance rules for private equity transactions? Are there any advantages to going private in leveraged buyout or similar transactions? What are the effects of corporate governance rules on companies that, following a private equity transaction, remain or later become public companies?

Indian corporate governance rules vary for different types of companies. The Companies Act 2013 of India (CA 2013), which has been introduced in a phased manner since 12 September 2013, generally imposes stricter governance and disclosure norms on Indian companies than its predecessor, the Companies Act 1956 of India (to the extent that it has been replaced). However, private companies continue to be subject to relatively lesser scrutiny and are exempt from complying with several governance-related provisions of CA 2013. For example, as per CA 2013:

- in the case of a listed company, at least one-third of the board should be comprised of independent directors; and
- in the case of unlisted public companies (which meet the prescribed thresholds), at least two members of the board should be independent directors.

Further, the boards of listed companies and unlisted public companies (which meet the prescribed thresholds) must comprise at least one woman director. In addition to the compliance requirements prescribed under CA 2013, listed and unlisted public companies are also required to comply with the regulations prescribed by the Securities and Exchange Board of India (SEBI). To illustrate, as per the regulations prescribed by SEBI, if the chairperson of a listed public company is an executive director, at least one-half of the board should comprise independent directors.

In addition, a person who has been a promoter of a company, or its holding, subsidiary or associate company, cannot be appointed as an independent director. The government has also indicated that large unlisted companies of systemic importance will soon be required to follow the more stringent financial reporting requirements that apply to listed companies, including the requirement to prepare quarterly or biannual audited financial statements in addition to the present requirement of annual audited financial statements.

Closely held public companies have stricter corporate governance norms than private companies, and public listed companies are subject to maximum scrutiny in terms of corporate governance and public disclosure. Public listed companies are subject to a number of corporate governance regulations specified by India's public markets regulator, SEBI, and the relevant stock exchanges, including under regulations pertaining to continuous listing, tender offers, insider trading and delisting. From the perspective of a PE investor, corporate governance and disclosure rules are set out either in shareholders' agreements or the charter documents, or both, in investments in private companies or closely held public companies. While this affords greater flexibility in prescribing strict governance norms, PE investors often face difficulties in having such norms followed given the lack of accountability and awareness of Indian promoters. On the other hand, investments in public listed companies offer PE investors greater protection on account of the higher levels of compliance required of such companies and the obligation to make public disclosures to shareholders of every material action, omission or event.

The SEBI has also released detailed guidelines relating to a regulatory sandbox – an ecosystem through which entities regulated by SEBI may test new solutions in a live environment with minimal regulation (no exemptions are to be granted from investor protection related guidelines, including know-your-customer and anti-money laundering rules.

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Issues facing public company boards

What are some of the issues facing boards of directors of public companies considering entering into a going-private or other private equity transaction? What procedural safeguards, if any, may boards of directors of public companies use when considering such a transaction? What is the role of a special committee in such a transaction where senior management, members of the board or significant shareholders are participating or have an interest in the transaction?

Directors of Indian companies are required to disclose their interest or concern at the time of their appointment and at the first meeting of each financial year, and any change in interest or concern during a financial year, at the first meeting subsequent to such change. In addition, directors are not permitted to participate in meetings where a contract or arrangement in which such directors are interested is being discussed. In the context of PE transactions, directors who are nominees of selling shareholders, or are otherwise interested or concerned with selling shareholders, are prohibited from participating in meetings where such transactions are being discussed. This ensures transparent and fair decision-making and is of particular relevance in PE transactions involving public listed companies where large numbers of public shareholders are affected by the terms of such transactions. In a move to instil confidence in the investment community, public markets and individuals acting as directors of companies, the government has taken steps towards amending CA 2013 and incorporating the recommendations of the Company Law Committee to decriminalise several company law offences, reduce fines generally and remove penalties for several minor omissions. To illustrate, effective from December 2020, contravention of the director disclosure obligations set out above no longer entails imprisonment as a punishment.

In addition to the aforementioned governance requirements, capital issuances by companies under CA 2013 require the approval of shareholders in most cases. In a preferential allotment of shares to a PE investor, shareholders have to approve the transaction by way of a special resolution (ie, the number of votes cast in favour of the resolution is not less than three times the number of votes cast against the resolution). In a secondary investment in a public company, shares are freely transferable under law, and the board ordinarily does not have any right to prevent a transfer. CA 2013 prescribes detailed disclosure requirements for determining the ultimate owners and control holders in Indian companies. Indian companies are now required to identify and maintain adequate records of and update the registrar of companies with the details of significant beneficial owners, namely, the natural persons (whether as an individual or through another intermediate holding vehicle) who, whether by themselves or together in concert with other shareholders, hold not less than 10 per cent of the share capital of the company or exercise significant influence or control in the company. Similarly, irrespective of their domicile or residency status, all natural persons are under an obligation to declare the nature of their interests to the company together with particulars of instruments embodying the transfer or acquisition of their beneficial interest.

In PE transactions concerning public listed companies, applicable regulations relating to tender offers, insider trading and delisting prescribe additional obligations on directors, including specific approvals for tender offers and going-private transactions. In tender offers, no person representing the acquirer may become a director of the target company, unless certain conditions are met (eg, 100 per cent of the consideration payable to public shareholders under the tender offer being deposited in an escrow account following the expiry of the competitive offer period). Further, if the target company's board already comprises a director representing the acquirer, then such director is not allowed to vote on any matter relating to the tender offer.

From the perspective of Indian insider trading laws, PE firms often take a pragmatic view on the nomination of directors on boards of directors of Indian listed companies. A PE nominee director may have access to material that is 'unpublished price-sensitive information' in his or her capacity as a director, which may taint, or otherwise restrict the ability of the PE investor to deal in securities until such information either comes into the public domain or no longer continues to be price sensitive. PE firms need to also be mindful of certain revisions to insider trading regulations. The revisions require PE firms to exercise more caution in their nomination of directors. The revisions have introduced standardised processes for reporting code of conduct violations to SEBI, recategorised exemptions with respect to the transfer of 'unpublished price-sensitive information' between insiders and bona fide transfers for regulatory reasons, and exemptions for disclosures made as part of due diligence.

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Disclosure issues

Are there heightened disclosure issues in connection with going-private transactions or other private equity transactions?

In the case of a public listed company, a going-private transaction would, inter alia, require a mandatory exit option being given to the minority or public shareholders of the target company. The entire process of delisting requires, inter alia, in-principle approval from the concerned stock exchanges on which the public company had been listed, approval of the board of directors and two-thirds of the public shareholders and making newspaper advertisements for providing a mandatory exit to the public shareholders, etc. Akin to Rule 13e-3 disclosures and declarations, companies and shareholders are also required to provide adequate declarations to concerned stock exchanges at different stages of the delisting process. In addition, conversion of a public company into a private company requires approval of the registrar of companies (and in a squeeze-out through a scheme of capital reduction, approval of the courts too). Therefore, the process of going private under Indian law requires several disclosures to be made to both governmental authorities and the public.

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Timing considerations

What are the timing considerations for negotiating and completing a going-private or other private equity transaction?

The timeline for completion of PE transactions in India depends on a number of factors, including:

- the nature of the transaction;
- the sector of investment;

- regulatory requirements;
- anti-trust issues;
- deal size;
- due-diligence issues;
- structuring; and
- tax (both domestic and international) considerations.

PE transactions in private and closely held public companies in sectors that do not require regulatory approvals for making investments can be completed fairly expeditiously. Such transactions are ordinarily completed within four to six weeks of the term sheet being signed.

The timeline for completion of PE investments in regulated sectors (other than sensitive sectors, being those that require security clearance from the government) where transaction clearance is required from Indian regulators, including the Reserve Bank of India (RBI), the relevant administrative ministry, the Cabinet Committee on Economic Affairs, the Competition Commission of India and the Insurance Regulatory and Development Authority of India, is considerably longer and usually takes anywhere between eight and 20 weeks. The timeline for the completion of PE investments in sensitive sectors usually takes between four and six months.

The government regulates FDI proposals in regulated sectors through competent authorities or ministries for specific sectors (administrative ministries) as per the Standard Operating Procedure, while the Department of Industrial Policy and Promotion continues to be the nodal authority to oversee all FDI proposals in India. For example, the Department of Pharmaceuticals is the relevant administrative authority for FDI proposals in the pharmaceutical sector and will examine FDI proposals in brownfield pharmaceutical companies exceeding 74 per cent. The government has also set up:

- a centralised investment clearance cell for entrepreneurs to ease doing business in India in 2021. This clearance cell is intended to provide pre-investment advisory information related to land banks and facilitate generally regulatory clearances; and
- an information system to serve as a one-stop solution for all trades and investors to access industrial information. This includes the availability of:
  - raw materials
  - horticulture;
  - agriculture;
  - minerals information;
  - layers of terrain;
  - natural resources; and
  - urban infrastructure.

Tender offers and going-private transactions are heavily regulated, and timelines are driven largely by procedural requirements under the law. Tender offers in India are typically completed within approximately eight weeks of the public announcement being made. However, tender acquisitions of public listed companies often take anywhere between three and four months on account of regulatory requirements and general complexities involved in transactions of such scale. The timeline may further be prolonged if there is a competing offer. Similarly, SEBI has set out detailed procedural requirements and documents along with specified timelines for carrying out different activities forming part of a going-private transaction. The delisting process in a going-private transaction is typically completed within approximately 11 to 12 weeks of board approval. However, the entire delisting process ordinarily takes about four to six months, and may be prolonged further if the acquirer seeks to squeeze out minority shareholders and convert a public company to a private company.

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Dissenting shareholders' rights

What rights do shareholders of a target have to dissent or object to a going-private transaction? How do acquirers address the risks associated with shareholder dissent?

SEBI's delisting regulations prescribe several checks and balances that ensure a fair delisting process. First, delisting requires the approval of the company's shareholders by a special resolution in addition to board approval. For purposes of the delisting regulations, approval of the delisting by a special resolution excludes the shares held by the company's promoters and only considers the shares held by the company's public shareholders. The number of votes cast by public shareholders in favour of delisting should be at least twice the number of votes cast against the delisting. This exclusion ensures a fair and unbiased review of delisting terms, as promoters, who typically hold a majority of the company's shares, are unable to exert undue influence on the decision to delist the company's shares.

Second, the delisting regulations grant dissenting shareholders an exit opportunity for up to one year to tender their shares to the acquirer after the company's shares have been delisted.

Third, the final offer price in a delisting offer is determined through a reverse book building (RBB) process where the final offer price is the price at which shares accepted in the offer achieve the prescribed delisting threshold of 90 per cent of the total issued capital. As the final offer price is subject to the number of shares required to achieve a successful delisting offer, the offer price can be substantially impacted by shareholders with substantial holdings in the company. This acts as a further deterrent to promoters, as the price determination process ensures that public shareholders are treated fairly. However, the delisting regulations permit the acquirer or promoters that are dissatisfied with the price discovered under the RBB process to make a counter-offer of a more attractive price to public shareholders.

The counter-offer has to be made within two working days of the discovery of the price and should not be less than the book value of the company as certified by the merchant banker to the delisting process. The counter-offer will be deemed to be successful only if the post-offer promoter shareholding (together with persons acting in concert) taken together with the shares accepted in the counter-offer price reaches 90 per cent of the total issued shares of that class.

SEBI has recently eased rules for the delisting of listed subsidiaries of listed parent companies. Such subsidiaries are exempt from the RBB process if the subsidiary and the listed parent are in the same line of business. SEBI has also published a discussion paper that proposes to enhance disclosure requirements to help investors in making informed decisions, rationalising timelines and generally streamlining the delisting process.

There is also continual regulatory oversight in the delisting process. Companies are required to obtain in-principle approvals of stock exchanges prior to the public announcement for delisting. Thereafter, upon completion of the bidding process, companies are required to obtain final approvals for delisting from stock exchanges. The final approvals are subject to companies furnishing adequate proof of having given public shareholders an exit opportunity.

Upon delisting of the company, an acquirer that desires to take the company private will need to seek the conversion of the company from a public company to a private company. The conversion process requires an amendment to the company's charter documents, which can only be approved by a special resolution of the company's shareholders.

There are limited options for acquirers to address the risks associated with shareholder dissent, as the delisting process is meant to be fair to, and protect, public shareholders. A widespread issue faced by acquirers in going-private transactions is the presence of several minority shareholders even after the completion of the delisting process. While minority shareholders cannot ordinarily interfere in the operation and management of companies, they can be an impediment to a company's functioning. Another common problem faced by acquirers in going-private transactions is the inability of majority shareholders to approve bona fide related-party transactions on account of a significant number of minority shareholders preventing business from being conducted. In such cases, acquirers are forced to squeeze out minority shareholders. Squeeze-outs are relatively unevolved in India. There are limited options available to majority shareholders to force a squeeze-out in a manner that will be favourable with the minority shareholders and also applicable regulators. Majority shareholders were often forced to implement court-sanctioned minority squeeze-out schemes where the company's share capital is reduced selectively. In addition to being a drawn-out process, the price offered by the company in such schemes of capital reduction will almost always be higher than the price offered to shareholders in the delisting process. CA 2013 now provides for the squeeze-out of minority shareholders without the involvement of the courts. Majority shareholders who own 90 per cent or more of a company's share capital may now offer to buy out minority shareholders at a price determined by a registered valuer. Minority shareholders are also permitted to offer to sell their holdings to the majority shareholders at the aforementioned price, irrespective of an offer having been made by the majority shareholders. The provisions also permit minority shareholders to participate in upside sharing on any future deal for the sale of shares by the majority shareholders at a price that is higher than the price offered to the minority shareholders, subject to the holders of at least 75 per cent of the minority shareholding agreeing to renegotiate the buyout price.

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Purchase agreements

What notable purchase agreement provisions are specific to private equity transactions?

Other than adaptations for Indian law, the fundamental provisions of PE transaction documents are largely the same as the corresponding provisions of PE transaction documents for investments in the United Kingdom or the United States. Purchase agreements involving PE transactions are customarily buyer-friendly.

Transaction documents customarily include extensive representations and warranties (R&Ws) on:

- corporate existence;
- power and authority;
- business and operations of the target company;
- title to shares;
- financial statements;
- financial indebtedness;
- absence of material adverse change;
- compliance with laws;
- the validity of licences and approvals;
- intellectual property;
- labour;
- real property; and
- anti-corrupt practices (in the case of certain foreign PE investors).

These R&Ws are sought from both the company and its promoters or selling shareholders, depending on the nature of the transaction. R&Ws are backed by indemnities, which are lately also being underwritten with R&W insurance. Specific disclosures and material due-diligence issues are addressed with specific indemnities with no or very few limitations. Indemnity provisions are the subject of many negotiations. Parties agree on multiple limitations on indemnification, including caps on liability, de minimis and basket thresholds, survival periods for making claims, and offsets against recoveries through insurance, etc. Fundamental R&Ws (power and authority, title to shares, etc), specific indemnities and R&Ws pertaining to taxes are carved out from the survival period and other limitations for other R&Ws, and are subject to either fewer or no limitations. Target companies and promoters resist perpetual indemnification obligations, and survival periods depend on the period for which the company has been in existence.

PE investors are reluctant to give any R&Ws pertaining to a company's business in stake sales of portfolio companies. R&Ws are limited to the investor's ability to conclude the transaction, its title to the shares being sold and seller's taxes in connection with the sale shares. There are limited instances where PE investors agree to give R&Ws on the company's business, and such provisions are commonly found in buyout transactions where an existing investor controls the portfolio company or plays an active role in its management. Indemnities are typically limited to breaches of the limited R&Ws provided by the PE investor, and are often underwritten by insurance. In certain transactions involving the sale of shares by a foreign PE investor to another foreign PE investor, indemnities for any indirect transfer taxes become a vital component of the share purchase agreements. Buyers usually agree to robust tax indemnities for transfer taxes, which are underwritten by insurance and, at times, a guarantee from the seller's general partner or a financial sufficiency covenant that is co-terminus with the indemnity obligation. Provisions relating to a holdback of consideration for potential claims and other purchase price adjustments, including working capital earn-outs, are also common, and are accompanied by escrow agreements to document conditions and processes for the release of holdback consideration.

PE transactions concerning public listed companies often contain limited R&Ws. Promoters agree to indemnify a limited extent of all claims citing their limited control of operations in spite of majority ownership. As leveraged buyouts are generally not permitted in India, provisions pertaining to acquisition financing are infrequent, and are usually limited to comfort letters from limited partners or soft commitments of other offshore sources of finance.

Almost all PE transactions contain restrictive covenants on promoters, and in limited instances, PE investors. Non-compete provisions are generally not enforceable in India, unless reasonable in scope or in cases where the goodwill of a business is being sold along with the company's shares. In buyouts and going-private transactions, ownership and usage of intellectual property post-acquisition becomes relevant. In addition, acquirers often insist on a transition period where promoters (and their brand) continue to be associated with the company to ensure a smooth operational transition.

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Participation of target company management

How can management of the target company participate in a going-private transaction? What are the principal executive compensation issues? Are there timing considerations for when a private equity acquirer should discuss management participation following the completion of a going-private transaction?

Indian companies are mostly promoter-owned and controlled. PE investors prefer that promoters and their key managerial personnel continue, post-acquisition, to be involved in the management and operation of companies for a transition period post-acquisition. Promoters maintain executive roles in the company. Therefore, the transaction documents for PE transactions often contain restrictive covenants regarding competition, solicitation and confidentiality.

Promoters and other key managerial personnel are compensated in the form of earn-outs, equity incentive schemes and other similar milestone-based compensation schemes. Such compensation packages are in addition to any consideration such individuals receive for the sale of their holdings in the company pursuant to a PE transaction.

As discussed earlier, in listed company acquisitions and going-private transactions, promoters and key managerial personnel have defined transitional periods requiring them to remain committed to the company to ensure a smooth operational transition. Such arrangements are of particular relevance in service-based businesses where key customer relationships must be handed over to new management. Most such transactions do not involve the replacement of the company's management in its entirety. Several key existing managerial personnel continue to remain employed by the company post-acquisition, as such individuals remain fundamental to the continued growth of the company.

In all of the above, discussions with promoters and the existing management begin in advance of transaction documentation, and are often documented as conditions to transaction closure. Employment and other agreements are executed either at or prior to closing.

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Tax issues

What are some of the basic tax issues involved in private equity transactions? Give details regarding the tax status of a target, deductibility of interest based on the form of financing and tax issues related to executive compensation. Can share acquisitions be classified as asset acquisitions for tax purposes?

There are specific pricing provisions governing Indian companies and investors that require primary investments to be priced appropriately. From a target's perspective, if shares are issued to resident investors at a price higher than the fair market value, as determined on the basis of specific formulae prescribed by tax laws, the target will be charged (subject to certain exceptions) to tax on the excess so received as income in its hands. Lately, the Indian tax authorities have been examining share premiums charged by Indian companies on the allotment of shares to non-residents and are attempting to tax Indian companies on excessive share premiums. A valuation report from an independent reputed valuer supporting a share allotment and the premium charged is advisable.

Primary investments in closely held Indian companies are not taxable in the hands of investors, unless, in the case of equity and preference shares, such shares have been acquired below fair market value. In such cases, the investor is taxed on the difference between the acquisition price and the fair market value of the shares, as the difference is treated as income in the hands of the investor. The conversion of both convertible debentures and preference shares into equity shares are specifically exempt under Indian tax laws.

The government has introduced a tax collection at source (TCS) component, whereby a seller of goods is required to collect tax at the rate of 0.1 per cent, over and above the consideration, from the buyer. TCS is not applicable where the buyer has withheld taxes from the payment of purchase price. Subject to the seller meeting certain conditions, including having a business turnover of more than 100 million Indian rupees, the TCS provisions extend to off-market security transactions. Before examining this TCS implication, it is important to examine whether the buyer is instead required to have tax deducted at source (TDS) on the payment of sale consideration to the seller. As per the TDS provisions introduced in the 2021 to 2022 Union budget of India, a buyer of goods is required to withhold tax at the rate of 0.1 per cent when buying goods from an Indian resident. The withholding obligation only exists where the consideration for goods exceeds 5 million Indian rupees and the buyer had a business turnover of more than 100 million Indian rupees in the immediately preceding year. Both the TCS and the new withholding tax may be construed as big-brother measures introduced by the government to have all material transactions reported effectively. The withholding tax rate is proposed to be increased to 5 per cent where the seller has not obtained certain prescribed tax registrations, an unlikely scenario in the case of resident sellers transacting in high-value transactions. While the seller would not be required to collect TCS where the buyer withholds taxes, the proposed amendment will increase the compliance burden for the buyer, especially non-resident buyers not having any business in India. The Central Board of Direct Taxes (the apex rule-making authority for income-tax) has relaxed the TDS rules for non-residents pursuant to which a non-resident buyer not having a permanent establishment in India, is not required to levy TDS on payment made to an Indian resident.

A non-resident investor will be taxed in India, subject to relief as available under the relevant tax treaty between India and the country of residence of the investor.

Gains on transfers of shares are taxable at rates based on:

- the period of holding;
- the type of holder;
- the type of company, and
- whether the shares are transferred on-market or off-market (in the case of transfers of shares of listed companies).

Transfers include transactions such as share buybacks and redemptions. In unlisted companies, gains are treated as short-term if shares are held for a period of up to 24 months, and long-term if shares are held for a period of more than 24 months. For non-resident sellers (other than foreign portfolio investors (FPIs)), such short-term gains are taxable at 40 per cent in the case of corporate entities and 30 per cent in all other cases; and long-term gains are taxable at 10 per cent for all types of non-resident taxpayers. The 10 per cent concessionary tax rate for long-term capital gains on the transfer by non-resident taxpayers of shares of unlisted companies applies with retrospective effect from the 2012 to 2013 financial year onwards. In listed companies, gains are treated as short-term if securities (including shares) are held for a period of up to 12 months and long-term if securities (including shares) are held for a period of more than 12 months. If the shares are sold on-market, such short-term gains are taxable at 15 per cent and long-term gains in excess of 1 million Indian rupees are taxed at 10 per cent, provided that securities transaction tax is paid at both the time of acquisition and disposal. Further, in relation to shares acquired on or prior to 31 January 2018, their fair market value on 31 January 2018 is allowed to be substituted (subject to conditions) as the cost of shares for computing taxable capital gains. On-market transfers are also subject to payment of securities transaction tax of 0.01 to 0.125 per cent, based on the type of on-market transaction. In off-market transfers, short-term gains are taxable at 40 per cent in the case of corporate entities, and 30 per cent in all other cases, and long-term gains are taxable at 10 per cent.

All of the above capital gains tax rates are exclusive of applicable surcharges and education levies. In relation to individuals and unincorporated associations, a surcharge applies at the rate of 37 per cent if the income exceeds 50 million Indian rupees – with a notable exception for long-term capital gains from the on-market sale of listed shares where a surcharge is capped at 15 per cent. The 2022 to 2023 Union budget of India seeks to cap the surcharge to 15 per cent in all cases of long-term capital gains – thereby reducing the effective tax rate for residents from 28.5 per cent to 23.92 per cent; and for non-resident share sale from 14.5 per cent to 10.92 per cent. This relief brings parity between the taxation of listed and unlisted shares.

In computing the capital gains on the transfer of shares of unlisted companies, if the consideration for such transfer is less than fair market value, as determined on the basis of specific formulae prescribed by tax laws, such fair market value shall be deemed to be the full value of the consideration received for purposes of computing capital gains. A similar anti-abuse provision also applies to transfers of immovable property of a value less than the value determined for the computation of stamp duty. Interestingly, a corresponding provision based on the same rationale also applies to the purchaser of shares, whereby if the fair market value of shares is higher than the consideration paid by the purchase of shares, the difference is taxed as the purchaser's ordinary income.

Additionally, capital gains on the transfer of shares of a foreign company are subject to tax in India, subject to certain exemptions, if the shares of the target foreign company derive their 'value substantially' from Indian assets (ie, the value of such assets represents at least 50 per cent of the value of all the assets owned by the target foreign company and exceeds 100 million Indian rupees). The value of such Indian assets as well as all the assets owned by the foreign company is determined on the basis of specific formulae prescribed by tax laws. Indian tax laws also prescribe additional disclosure requirements in multilevel holding structures to facilitate such determination.

Transfers by non-resident sellers to resident buyers or non-resident buyers are subject to withholding of the requisite amount of capital gains tax. Non-resident investors, other than registered FPIs, may also be subject to lower tax rates depending on their eligibility to claim benefits under the applicable tax treaty between India and their country of residence. Registered FPIs are subject to a special tax regime under Indian tax laws.

Non-resident sellers were historically exempt from paying capital gains tax if their investments were structured through jurisdictions having a favourable double taxation avoidance agreement with India. Cyprus, Mauritius, the Netherlands and Singapore were the most popular jurisdictions for PE investors to invest in Indian companies, as capital gains and dividends are not taxable and income tax rates are low. India has amended its double taxation avoidance agreements with Cyprus, Mauritius and Singapore to be able to tax capital gains arising out of a direct disposal of Indian assets. These are key jurisdictions from which substantial foreign investment has been received in the last few years. Equity shares acquired prior to 1 April 2017 by PE investors based in Cyprus, Mauritius and Singapore will continue to be tax-exempt. Equity shares acquired by PE investors based in Mauritius and Singapore on or after 1 April 2017 but transferred on or after 1 April 2019 will be taxed at full applicable domestic Indian capital gains tax. Equity shares acquired by PE investors based in Cyprus on or after 1 April 2017 will be taxed at applicable domestic Indian capital gains tax. Compulsory convertible debentures and non-convertible debentures are exempt from capital gains tax for investors based in Cyprus, Mauritius and Singapore. India is a signatory to the Multilateral Convention under the base erosion and profit shifting programme of the Organisation for Economic Co-operation and Development and G20 countries, whereby India’s treaties with several countries (including Singapore) stand modified by several anti-abuse provisions of the Multilateral Convention like the principle purpose test.

The government had introduced the General Anti-Avoidance Rules (GAAR) from 1 April 2017. It is now imperative to demonstrate that there is a commercial reason, other than for obtaining a tax advantage, for structuring investments out of tax havens. GAAR can be used to challenge arrangements with the main purpose of obtaining a tax benefit and for denying benefits otherwise available under a tax treaty. Income arising from the transfer of investments acquired before 1 April 2017 have been grandfathered from the applicability of GAAR.

Further, a foreign company is to be treated as tax resident in India if its place of effective management (PoEM) is in India. The PoEM is ‘a place where key management and commercial decisions that are necessary for the conduct of the business of an entity as a whole are in substance made’. If the foreign company becomes resident in India, it would be taxed at an effective rate of 41.2 per cent to 43.26 per cent on its global income in India. However, the government has announced that non-residents not having a PoEM or permanent establishment in India who are in receipt of income from interest or dividend or royalty or fee for technical services and in whose cases the due tax has been deducted at source (without considering any tax treaty benefit), will not be required to file their returns of income in India.

With effect from April 2021, the definition of residents under the Income Tax Act 1961 of India treats Indian citizens who have an aggregate income exceeding 1.5 million Indian rupees and are not liable to tax in any other country by reason of domicile or residence or any other such criteria, as a resident in India for tax purposes. Accordingly, PE investors must exercise caution while structuring their fund management structures, and in some cases their investments, in Indian companies.

Indian companies, irrespective of their ownership and control, continue to be taxed in India on their corporate income at a rate of 30 per cent (exclusive of applicable surcharges and levies). In a significant move that makes India on a par with international jurisdictions in terms of corporate income tax rates, Indian companies now have the option to pay tax at a rate of 22 per cent from the 2019 to 2020 financial year if they do not avail themselves of any exemptions or incentives, or claim deductions in the computation of their taxable income. Indian companies opting for these concessional tax rates will also not be eligible to claim credits for taxes paid under minimum alternate tax during the tax holiday period and will not be entitled to claim set-off of any brought-forward depreciation for the assessment year in which the option has been exercised and thereafter for future assessment years. The government has also offered manufacturing companies a lower corporate income tax rate of 15 per cent. The above measures are aimed at incentivising the Indian economy. In addition, from the 2021 to 2022 financial year, as an incentive to start-ups, the turnover cap to avail of 100 per cent income tax exemption for three consecutive years (out of the first 10 years) has been increased from 250 million Indian rupees to 1 billion Indian rupees.

Dividend distribution tax (DDT) payable by Indian companies on dividends declared to shareholders has been abolished with effect from April 2020. Indian companies were earlier required to pay DDT (at an effective rate of 20.56 per cent, including surcharge and cess) in addition to corporate income tax. Indian companies are no longer liable to pay DDT on dividends distributed. Dividends are now taxed directly in the hands of shareholders (based on applicable tax rates for residents and at 20 per cent for non-residents). Indian companies would only be required to withhold applicable tax at 10 per cent for residents (for dividends more than 5,000 Indian rupees) and 20 per cent for non-residents.

A shareholder is allowed a deduction only for interest expenditure against the dividend income (up to a cap of 20 per cent of such dividend income). No other deductions are allowed. Dividends received by an Indian company from another Indian company are also not subject to tax on dividends, provided the dividend income is distributed at least one month prior to the date of filing tax returns.

Interest income on Indian rupee-denominated debt is subject to withholding tax at a rate of 40 per cent, unless the debt investment is structured through a tax-friendly jurisdiction and the borrowing is structured as a bond with an interest rate that is below a prescribed rate. In such cases, the withholding rate can be reduced to 5 per cent if such bonds are issued prior to 30 June 2023. Debt investments by PE investors through non-convertible debentures (NCDs) and 'masala bonds' are tax-friendly as a result. Interest income on foreign currency debt is subject to withholding tax at a rate of between 5 per cent and 20 per cent, depending on several factors. As Indian laws do not permit PE investors to avail themselves of domestic acquisition financing, PE investors are not ordinarily subject to withholding tax in India. With effect from 1 April 2017, NCDs issued to investors based in Mauritius enjoy a 7.5 per cent withholding tax rate on interest income, as compared with 15 per cent for those based in Singapore and 10 per cent for those based in Cyprus.

Employees in India are subject to individual income tax at varied slabs. Indian income tax laws follow a progressive slab rate for individuals. No new changes have been introduced in the slab rates for different income levels in the 2022 to 2023 Union budget of India, and the highest slab rate remains 30 per cent, which after the imposition of surcharges intended to tax India's super-rich, may increase to 42.74 per cent (inclusive of all applicable cess, surcharges and levies). Income received pursuant to the exercise of stock options, severance payments and golden parachutes are taxed as salary. Indian tax laws do not permit parties to treat share purchase transactions as asset acquisitions.

The government has introduced Gujarat International Finance Tec-City (GIFT City) in an attempt to create an international financial centre that is at par with globally benchmarked financial centres. GIFT City is deemed a foreign territory dealing in foreign currency and the units therein are recognised as non-residents under the RBI regulations. Benefits extended to international financial services centres in GIFT City include exemptions on transfers of certain specified instruments held by domestic alternate investment funds, 100 per cent tax holiday for 10 consecutive years, exemption on interest for external commercial borrowings, etc. The 2022 to 2023 Union budget of India seeks to further exempt non-residents' income arising on transfer of offshore derivative instruments or over-the-counter derivatives entered into with an International Financial Services Centre (IFSC) banking unit as also income from a portfolio managed or administered by a portfolio manager in an account maintained in an IFSC banking unit. An exemption is also proposed to be granted in relation to angel tax (ie, the tax applicable to a closely held Indian company on the issuance of shares to a resident at a premium in excess of fair value) to an Indian company in relation to the issuance of shares to an alternative investment fund regulated under the prescribed IFSC regulation.

Over the course of the past year, the government has introduced substantial amendments to the erstwhile stamp duty regime with an intention to facilitate ease of doing business and bring in uniformity in stamp duties on the issue and transfer of securities. The amendments relate not only to the rates of stamp duty but also to the process of levying and collecting such duties. Notably, the exemption from payment of stamp duty on the transfer of dematerialised shares has been removed. Similarly, only marketable debentures were earlier subject to stamp duty. This specification has now been omitted. Although these changes are likely to enhance transaction costs, the rates of stamp duty that ordinarily apply to PE transactions have generally been reduced.

Law stated - 09 February 2022

DEBT FINANCING

Debt financing structures

What types of debt financing are typically used to fund going-private or other private equity transactions? What issues are raised by existing indebtedness of a potential target of a private equity transaction? Are there any financial assistance, margin loan or other restrictions in your jurisdiction on the use of debt financing or granting of security interests?

The Reserve Bank of India (RBI) prohibits Indian banks from granting loans for purposes of the acquisition of shares. Only non-banking financial companies may lend monies for purposes of acquisition financing. However, borrowing costs and limitations on the extent of leverage that may be availed prevent private equity (PE) investors from borrowing from such institutions. In addition, foreign direct investment laws prohibit foreign PE investors from leveraging domestic markets to make investments in India. Any form of acquisition financing is limited to offshore sources, which can be problematic given restrictions on the creation of security on Indian assets in favour of non-resident lenders. Indian exchange control regulations prohibit Indian parties from pledging their shares in favour of overseas lenders if the end-use of the borrowing is for any investment purposes directly or indirectly in India. Structures using Indian companies that are owned or controlled by foreign investors are also not feasible, as such companies are prohibited from raising any debt from the Indian market to make any further downstream investments. Public companies (including private companies that are subsidiaries of public companies) are not allowed to provide any security or financial assistance for the acquisition of their own securities. The assets of such Indian companies cannot be leveraged for the purposes of acquisition financing as a result.

Privately placed non-convertible debentures (NCDs) are a popular form of debt financing for foreign PE investors. NCDs are less regulated than overseas loans, and can be secured by Indian assets, as applicable regulations mandatorily require the appointment of an Indian debenture trustee to hold security on behalf of the debenture holders. There are no caps on the returns a PE investor can make on NCDs. NCDs issued to foreign portfolio investors (FPIs) are no longer mandatorily required to be listed and are liquid instruments in the hands of the PE investor. Further, there are limited end-use restrictions only on privately placed unlisted NCDs. PE investors may therefore consider investing in listed NCDs to finance domestic acquisitions. However, the RBI prescribes limits on the extent of a single issuance in which FPIs can participate. An investment by an FPI should not exceed 50 per cent of the total NCDs offered in a single issue. Consequently, PE investors that use proprietary or third-party FPIs to provide acquisition finance to equity transactions in which they may be participating are now limited by the cap on participating in any issue of NCDs. PE investors are now required to involve third-party FPIs in such transactions, or to execute offshore derivative trades or funded participation with other eligible lenders (who would subsequently lend to the issuer). The RBI also restricted FPIs from subscribing for more than 20 per cent of the debt portfolio in a single corporate group. This restriction, which stemmed from the RBI's insistence on diversification of risk for investors in FPIs, has since been withdrawn. The RBI has also introduced the voluntary retention route (VRR) investment mechanism to enable FPIs to invest in debt markets in India without any restrictions on minimum residual maturity, participation and investment concentration, subject to a minimum retention period of three years, provided that FPIs retain at least 75 per cent of invested capital in India for such period. In addition to VRR, the government has permitted FPIs to invest up to 30 per cent of their total investments in short-term corporate bonds having residual maturity of up to one year (as against the three years otherwise prescribed for investments in corporate bonds), subject to separate monitoring. The RBI has increased the aggregate limit of FPI investments in corporate bonds from 9 per cent to 15 per cent of the total issued India corporate debt.

SEBI has also amended certain regulations for imposing more stringent norms to secure the interest of investors in listed debt securities and to enable debenture trustees to perform their duties more effectively. These amendments are applicable for the issues proposed to be listed on or after 1 January 2021.

Another form of debt financing is the use of masala bonds. Masala bonds were notified by Indian regulators in September 2015, and are Indian rupee-denominated debt instruments that may be issued to overseas lenders. As such instruments are denominated in Indian rupees, overseas lenders are expected to bear the risk of exchange rate fluctuations. Since their introduction, PE investors have not used masala bonds to finance domestic acquisitions. This is largely owing to a prevailing view that proceeds raised through the issuance of masala bonds cannot be used for capital markets and domestic equity investments. In addition, Indian regulators introduced additional conditions on the issuance of masala bonds in 2017 that have reduced the flexibility to structure such investments. For example, all masala bond issuances now require prior RBI approval.

Law stated - 09 February 2022

Debt and equity financing provisions

What provisions relating to debt and equity financing are typically found in going-private transaction purchase agreements for private equity transactions? What other documents typically set out the financing arrangements?

As acquisition financing is generally not permitted in India, the transaction documents for going-private transactions typically do not contain provisions relating to debt or equity financing. However, it is fairly commonplace for transaction documents to contain representations and warranties (R&Ws) made by PE investors about their financial wherewithal and bona fide sources of funds. In addition, transaction documents often contain a financing condition that permits PE investors to walk away from a transaction if financing is not forthcoming. Transaction documents also require the company and sellers to support any financing, including by agreeing to disclose information and facilitate meetings with the management. In auction processes and large transactions, it is common for the seller to request equity commitment letters or financing arrangements to demonstrate the purchaser's ability to perform its obligations. Lately, sellers have sought bank guarantees from PE investors to underwrite the performance of their obligations under transaction documentation.

Law stated - 09 February 2022

Fraudulent conveyance and other bankruptcy issues

Do private equity transactions involving debt financing raise 'fraudulent conveyance' or other bankruptcy issues? How are these issues typically handled in a going-private transaction?

Fraudulent conveyance and other bankruptcy issues do not arise in light of our responses relating to restrictions on acquisition financing. However, PE transactions typically contain R&Ws on solvency.

Law stated - 09 February 2022

SHAREHOLDERS' AGREEMENTS

Shareholders' agreements and shareholder rights

What are the key provisions in shareholders' agreements entered into in connection with minority investments or investments made by two or more private equity firms or other equity co-investors? Are there any statutory or other legal protections for minority shareholders?

Shareholders' agreements contain customary minority protection rights, such as:

- information rights;
- corporate governance rights (board seats, affirmative voting rights, veto rights, etc);
- restrictions on the transfer of shares (including lock-in restrictions, rights of first refusal or rights of first offer, co-sale rights, etc);
- anti-dilution protection;
- pre-emptive rights on future capital issuances;
- exit rights (IPOs, buyback options, put options, etc);
- liquidation preference; and
- drag-along rights.

Under the law, minority shareholders holding more than 25 per cent of the voting rights of a company have the power to block all special resolutions. Approval by a special resolution is required for all material corporate actions, including certain share issuances, alteration of charter documents in certain cases, and winding up, etc. Further, the holders of 10 per cent or more of the share capital of a company, or 10 per cent or more of the total number of members, or 100 or more members, can initiate proceedings against the company or its shareholders for oppression or mismanagement or both.

Law stated - 09 February 2022

ACQUISITION AND EXIT

Acquisitions of controlling stakes

Are there any legal requirements that may impact the ability of a private equity firm to acquire control of a public or private company?

The acquisition of control of Indian companies may be regulated or restricted on account of regulations relating to tender offers in listed company acquisitions, and exchange control regulations relating to foreign direct investment (FDI) in sectors having investment caps.

Under tender offer regulations, any acquisition of shares or voting rights entitling the acquirer (along with persons acting in concert) to exercise 25 per cent or more voting rights in a public listed target company requires such acquirer (and the persons acting in concert) to make an offer to the public shareholders to acquire at least 26 per cent of the voting shares of the target company. Tender offer regulations also prescribe other means of consolidation if an acquirer already holds a substantial stake in the target company, including norms relating to creeping acquisitions where up to 5 per cent of the voting rights in a target company may be acquired in a fiscal year. That said, the tender offer regulations also set out certain acquisitions that are exempted from the requirement to make a tender offer. Examples include acquisitions pursuant to a scheme of arrangement pursuant to an order of a court or a tribunal or a governmental authority, and acquisitions of stressed companies pursuant to a resolution plan approved under the Insolvency and Bankruptcy Code 2016.

Under Indian exchange control regulations, FDI in certain regulated sectors is not permitted beyond a specified limit. For example, FDI in the defence sector under the automatic route is limited to 74 per cent. Further, under exchange control regulations, downstream investments by an Indian company that is not owned or controlled by resident Indians are considered downstream foreign investments private equity (PE) investors looking at control or ownership of Indian companies have to be cognisant of this requirement, as Indian business groups with multiple subsidiaries engaged in activities falling under different sectors for purposes of FDI will need to comply with sectorial caps and investment conditions, including pricing and valuation guidelines, prescribed under Indian exchange control regulations in respect of each such subsidiary.

Law stated - 09 February 2022

Exit strategies

What are the key limitations on the ability of a private equity firm to sell its stake in a portfolio company or conduct an IPO of a portfolio company? In connection with a sale of a portfolio company, how do private equity firms typically address any post-closing recourse for the benefit of a strategic or private equity acquirer?

Private sales and IPOs are the preferred modes of exit for PE investors in India. IPOs continue to be the exit route of choice for most PE investors, given larger access to capital in international and domestic public markets and free transferability of shares.

Limitations on private sales of unlisted Indian companies are largely contractual. Transfer restrictions under shareholders' agreements and charter documents, such as rights of first refusal, rights of first offer, co-sale rights, and put and call options, etc. In the absence of such restrictions, there are limited legal restrictions prescribed under Indian laws. Pricing guidelines under Indian exchange control regulations must be followed in a private sale to or by a non-resident. A sale of shares by a resident to a non-resident cannot be effected at a price that is lower than the fair value of the shares of the portfolio Indian company, as determined by a chartered accountant or merchant banker based on an internationally accepted valuation methodology on an arm's-length basis. The above floor price operates as a cap in a transfer of shares from a non-resident to a resident. No such pricing restrictions apply to a transfer of shares by a non-resident to another non-resident. In a private sale of shares of a listed company, the benchmark price is the price at which a listed company may undertake a preferential allotment of securities under applicable SEBI regulations. Foreign venture capital investors registered with SEBI are exempt from entry and exit pricing guidelines. In PE investments where non-residents have been granted put or call options, the shares held by such non-residents are subject to a lock-in period of one year (or any higher period, as prescribed for the relevant sector). In addition to pricing guidelines, sectoral conditions and investment caps presented under FDI laws apply to sales of portfolio companies. Further, both the buyer and seller must be cognisant of anti-trust issues and potential anti-trust filings if certain thresholds relating to assets and revenues are met or if the transaction is likely to have an appreciable adverse effect on competition in India.

IPOs are the exit method of preference for PE investors. Almost all shareholders' agreements obligate the company and its promoters to provide PE investors with an exit through an IPO within a defined timeline. IPO clauses in shareholders' agreements prescribe that the IPO must either be an offer for sale of existing shares or a combination of a fresh issue of shares and an offer for sale. PE investors negotiate that they will have priority to offer up to all their shares as part of an offer for sale. IPO clauses also prescribe a minimum valuation at which the IPO must be undertaken for it to be considered a successful exit (ie, a qualified IPO). PE investors typically include veto rights on key components of the IPO process, including timing, pricing, the appointment of merchant bankers, and the stock exchange for the listing of shares. These obligations and conditions, however, are not entirely binding on the company and the promoters, as IPOs are largely market-driven. Obligations to conduct an IPO are usually on a best-efforts basis as a result. It is, therefore, difficult for PE investors that own minority stakes and do not control management to demand an IPO and force the process. In addition, as the IPO offer document is to be signed by all the company's directors, the fiduciary duties of directors may not permit the company to undertake an IPO on terms prescribed by PE investors if the directors feel that the IPO is not in the best interests of shareholders. The enforceability of IPO provisions in shareholders' agreements remains largely untested by the Indian courts.

An IPO through an offer for sale is treated similarly to an IPO by way of a fresh issuance under applicable SEBI regulations. The company must have a track record of profitability and net worth, and minimum net tangible assets, etc. Pursuant to recent amendments that have been introduced by SEBI, if the offer for sale is made by a company without having a track record, shares offered for sale by selling shareholders (individually or with persons acting in concert) holding:

- more than 20 per cent of the pre-issue shareholding of the issuer, shall not exceed 50 per cent of their pre-issue shareholding; and
- less than 20 per cent of the pre-issue shareholding of the issuer, shall not exceed 10 per cent of their pre-issue shareholding.

In view of the above, exits by PE investors through an IPO from companies that do not have a track record may be hindered.

In addition, PE investors must be cognisant of being named as 'promoters' in an IPO. PE investors with substantial stakes or considerable operational control may be named as 'promoters' in the offer document. A 'promoter' for the purposes of an IPO is subject to several responsibilities and obligations, including a lock-in on its shares. To illustrate, in the following scenarios, the promoter's shareholding is subject to a total lock-in period of 18 months (out of which 100 per cent of the promoters' shares are locked in for six months post-IPO, and thereafter, the minimum promoters' contribution, ie, 20 per cent of the post-issue share capital, is locked in for an additional period of 12 months):

- if the IPO issue involves only an offer for sale;
- if the end-use of more than 50 per cent of the fresh issue is not earmarked as capital expenditure for a project, excluding the offer for sale portion; and
- in the case of a combination of fresh issuance and offer for sale, end-use of more than 50 per cent of the issuance is not earmarked as capital expenditure for a project.

Additionally, all shareholders are subject to a six-month post-issue lock-in, except stock option holders who have been allotted shares prior to the IPO and certain registered domestic and foreign venture capital investors who have held shares in the company for at least one year prior to the date of filing of the draft offer document. Companies with majority PE ownership often do not undertake an IPO owing to the above restrictions, and look at secondary sales as preferable means of exit.

PE investors are reluctant to provide post-closing recourse to buyers. In most cases, recourse is limited to indemnities for breach of fundamental representations and warranties and tax claims on share transfers. Additionally, acquirers have lately been implementing earn-out structures as a measure to safeguard interests post-closing. However, upside sharing arrangements that a PE investor may enter into with promoters, directors, or key employees of listed companies to incentivise them and share returns beyond a hurdle rate require disclosure to stock exchanges and prior approval of the board and public shareholders. Promoters and interested shareholders are not permitted to vote on such matters.

Law stated - 09 February 2022

Portfolio company IPOs

What governance rights and other shareholders' rights and restrictions typically survive an IPO? What types of lock-up restrictions typically apply in connection with an IPO? What are common methods for private equity sponsors to dispose of their stock in a portfolio company following its IPO?

Public offers in India are primarily regulated by the Companies Act 2013 of India and the SEBI (Issue of Capital and

Disclosure Requirements) Regulations 2018. Stock exchanges grant listing approval only if special or additional rights available to shareholders under the company's charter documents are removed prior to listing. Typically, PE transaction documents do not contemplate the survival of any rights post-IPO. However, it is not uncommon to negotiate certain governance rights to continue post-IPO. PE investors often negotiate for a board seat or an observer right to survive post-IPO. Similarly, veto rights in certain cases have been known to survive post-IPO. There is ambiguity under Indian law as to the nature of veto rights. Negative control and positive control have not been clearly distinguished, and there is no definitive judicial pronouncement on this subject. In any case, any veto rights that stock exchanges do permit post-IPO are limited to actions affecting a PE investor's investment in the company.

Upon undertaking an IPO, the promoter's shareholding is subject to a total lock-in period of 18 months (out of which 100 per cent of the promoters' shares are locked in for six months post-IPO, and thereafter, the minimum promoters' contribution, ie, 20 per cent of the post-issue share capital, is locked in for an additional period of 12 months):

- if the IPO issue involves only an offer for sale;
- if the end-use of more than 50 per cent of the fresh issue is not earmarked as capital expenditure for a project, excluding the offer-for-sale portion; and
- in the case of a combination of fresh issuance and offer for sale, end-use of more than 50 per cent of the issuance is not earmarked as capital expenditure for a project.

Additionally, all shareholders are subject to a six-month post-issue lock-in, except stock option holders who have been allotted shares prior to the IPO and certain registered domestic and foreign venture capital investors who have held shares in the company for at least one year prior to the date of filing of the draft offer document.

In addition, Indian exchange regulations prescribe certain lock-in restrictions for FDI in certain limited sectors or certain situations. For example, FDI in construction and development projects is subject to a lock-in of three years. Post-IPO, PE sponsors may sell their shares either through negotiated deals either on or off-market. In on-market negotiated deals, the SEBI regulations permit 'block' and 'bulk' deals. Such transactions must take place during specified times and up to specified volumes or values. The ruling market price of the shares would be the purchase price in such transactions, except in a block deal where the price should not exceed 1 per cent above or below the applicable reference price FDI is not permitted through on-market transactions, unless the non-resident investor has acquired, and continues to hold, control of the target company and satisfies certain other conditions (including those stated above). Off-market transactions may take place at a negotiated price, subject to compliance with pricing guidelines prescribed under Indian exchange control regulations in the case of a non-resident seller or buyer. In both cases, parties should keep applicable tender offers and antitrust regulations in mind while structuring such transactions. Further, in the case of an investor who continues to have a board representation or otherwise has material price-sensitive information, while evaluating any transaction, it is also pertinent to assess the exemptions with respect to the transfer of 'unpublished price-sensitive information' between insiders and bona fide transfers for regulatory reasons, and exemptions for disclosures made as part of due diligence.

Law stated - 09 February 2022

Target companies and industries

What types of companies or industries have typically been the targets of going-private transactions? Has there been any change in industry focus in recent years? Do industry-specific regulatory schemes limit the potential targets of private equity firms?

Post-liberalisation of the Indian economy, the information technology and information technology-enabled services sectors have attracted the most attention from PE investors. Having said that, manufacturing, financial services, banking services, healthcare, consumer goods, real estate and pharmaceuticals have also witnessed several landmark PE investments.

In recent times, there has been an increased level of deal momentum in fintech (including payment systems and wallets), health-tech, digi-insurance, online gaming, social media intermediaries, online aggregators, e-commerce and ed-tech companies. In view of the increase in demand for stay-home schooling induced by the covid-19 pandemic, the ed-tech sector has been particularly active. For example, Indian ed-tech major Byju's recent capital raise values it at US $16.5 billion displacing China's Yuanfudao as the largest ed-tech player globally. It is expected that healthcare and allied services, financial technology, non-renewables and green energy will be the next big sectors. Further, the government has launched a production-linked incentives scheme covering 13 sectors and providing significant incentives to manufacture in India with an outlay of US$25 billion. This has encouraged investment in these sectors. The new National Monetisation Pipeline is aimed at inviting sovereign funds to participate in the infrastructure development of the country.

Indian exchange control regulations prescribe entry routes for FDI by setting out activities undertaken by companies in India that are prohibited from receiving FDI, that may receive FDI, subject to prior regulatory approval, and may receive FDI without any approvals (ie, the automatic route). These regulations also prescribe sectoral caps and conditions to be satisfied for FDI in certain sectors. Potential investment targets may be limited on account of Indian exchange control regulations prescribing sectoral conditions, investment caps, lock-in restrictions or minimum capitalisation.

In April 2020, the government had announced a critical change to FDI laws, pursuant to which prior approval of the government is required in the case of transactions where:

- the acquirer (in respect of both direct and indirect acquisition) is a resident or citizen of a country that shares a land border with India; or
- if the beneficial shareholder of the acquirer (if the acquirer is an entity) is a person who is a resident or a citizen of a country that shares a land border with India.

Prior to the amendment, only FDI from Pakistan and Bangladesh were subject to government approval. The intention behind the government's introduction of these new territorial investment restrictions has been stated to curb the opportunistic acquisitions of Indian companies pursuant to exigencies caused by the covid-19 pandemic. However, the primary intent appears to be to prevent any attempt by Chinese investors from taking significant stakes in Indian businesses. The government has not yet prescribed a bright-line test to define the extent of ownership or control that would constitute having a beneficial interest – strictly, the ownership of even one share by an investor in China would require prior approval. Based on market practice, the threshold for determining beneficial ownership typically ranges between a 10 per cent to 25 per cent shareholding in the acquirer (either directly or through any other holding structures). However, there have been a few recent cases wherein notices have been issued by regulators to acquirers for as low as 1 per cent ownership from a restricted territory. The government has also not clarified if FDI from politically sensitive territories like Hong Kong and Taiwan would be subject to the requirements of the amendment. This has resulted in authorised dealer banks that deal in foreign exchange and FDI to apply ownership and control standards prescribed under money laundering jurisdictions to FDI. The amendment does not also exempt certain investments. For example, the indirect acquisition of an Indian business pursuant to the acquisition of an offshore business that has limited operations in India would require prior approval from the government. Given the continued border tensions between India and China, government approvals for any FDI pursuant to the amendment have been slow to come. That said, there has been a recent increase in approvals coming through.

In October 2020, the Reserve Bank of India (RBI) had issued a directive prohibiting finance companies from receiving FDI from Mauritius and other jurisdictions that do not meet the benchmarks laid down by the Financial Action Task Force (FATF). Subsequently, in October 2021, the FATF removed Mauritius from the list of jurisdictions having strategic deficiencies with regard to the benchmarks laid down by the FATF. The RBI has taken due recognition of this via a press release, pursuant to which FDI from Mauritius is now permitted.

Law stated - 09 February 2022

SPECIAL ISSUES

Cross-border transactions

What are the issues unique to structuring and financing a cross-border going-private or other private equity transaction?

The primary considerations for structuring cross-border transactions are Indian exchange control regulations and tax implications.

Law stated - 09 February 2022

Club and group deals

What are some of the key considerations when more than one private equity firm, or one or more private equity firms and a strategic partner or other equity co-investor is participating in a deal?

Club or group deals are on the rise in India. Inter se rights of the private equity (PE) investors and alignment of their objectives are the principal considerations in group deals. Shareholders' agreements, including rights relating to exit, transfer restrictions, liquidation preference, anti-dilution protection, corporate governance and veto rights, should be carefully drafted to avoid potential conflicts among PE investors. Additional complications may arise when such transactions are structured among financial and strategic investors. As the objectives of financial and strategic investors are fundamentally different, the interplay of their individual rights, particularly in the case of exit rights and transfer restrictions, is of great importance. Although uncommon, several Indian companies have attracted investments from multiple strategic investors. In such group deals, due consideration must be given to rights affecting the ability of each strategic investor to acquire further shares in the company.

Consortium deals also need a special review from an antitrust perspective since existing investments of the consortium members may give rise to substantive competition issues if there are overlaps with a target's business.

Law stated - 09 February 2022

Issues related to certainty of closing

What are the key issues that arise between a seller and a private equity acquirer related to certainty of closing? How are these issues typically resolved?

Most closing conditions usually relate to due- diligence issues that need to be addressed prior to a PE investment. Having said that, promoters, selling shareholders and companies are reluctant to have extensive closing conditions, and negotiate extensively to limit closing conditions to fundamental issues only. Legal and regulatory conditions on account of Indian exchange control regulations, tax laws, and sector-specific regulations are unavoidable and usually non-negotiable. Similarly, buyers insist on the inclusion of third-party consents, such as lender consents. In listed company transactions, closing conditions are often limited to legal and regulatory conditions, and key consent requirements. Any due-diligence specific conditions are addressed separately prior to the execution of transaction documents and are not mentioned in the transaction documents.

A buyer is not obliged to invest upon a failure to fulfil closing conditions, and is usually granted the unilateral right to terminate transaction documents and walk away from the transaction. Conversely, sellers may seek either specific enforcement of closing or seek damages from a buyer, if a buyer does not intend to invest upon fulfilment of closing conditions. Break or termination fees, although uncommon in Indian transactions, may also be negotiated, particularly in auction deals, and such amounts are typically held in escrow or provided as a guarantee until closing. There are no regulatory restrictions on the extent of break fees that may be sought in Indian transactions. Market practice and precedents indicate that break fees are typically between 1 per cent and 3.5 per cent (with some cases going up to 5 per cent) of deal value. In most cases, break fees are structured as a flat fee, especially where the deal value is significant. The payment of break fees from an Indian resident to non-residents may entail certain Indian exchange control approvals. Where feasible, parties often structure break fees such that a non-resident affiliate of the Indian party (eg, an offshore group company) is obliged to make payment of the break fees.

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UPDATE AND TRENDS

Key developments of the past year

Have there been any recent developments or interesting trends relating to private equity transactions in your jurisdiction in the past year?

The private equity (PE) industry bounced back on a growth trajectory in 2021 with deal values increasing by approximately 57 per cent and volume increasing by 31 per cent, compared to 2020, ending the year with US$62.8 billion across approximately 1,200 deals – the highest-ever figures. Antara Capital, Tencent, Qatar Investment Authority, CPPIB, SoftBank Corp, Franklin Templeton PE, Tiger Global, GIC, and others' US$3.6 billion investment in Flipkart, Carlyle's US$3 billion acquisition of Hexaware Technologies, Blackstone's US$2.8 billion buyout of Mphasis, Tata Motors' fundraise from TPG and ADQ for US$1 billion for the electric passenger vehicle segment, and Blackstone's acquisition of Embassy Industrial Parks from Warburg Pincus and Embassy Group for US$714 million were a few of the marquee deals from 2021.

PE exits saw a resurgence in 2021, with 272 exits valued at US$38.8 billion as compared to 136 exits valued at US$4.2 billion in 2020. IT and ITeS companies led the pack with 109 deals worth US$23.5 billion, representing 60 per cent of the total value. As the public listing of companies continued to witness large-scale participation in 2021, exits through IPOs maintained a growth trajectory. Some 37 companies backed by PE investors were listed in 2021. The largest IPO in 2021 was PayTM, where Elevation Capital, SoftBank Corp, Ratan Tata, Alibaba, MediaTek, Berkshire Hathaway and Discovery Capital Management sold shares worth US$1.3 billion. The largest PE exit, however, involved CPPIB and Partners Group exiting their individual stakes of 45 per cent in GlobalLogic, along with the remaining shareholders, by way of a strategic sale to Hitachi for US$9 billion. Other notable secondary exits included General Atlantic, Temasek, Clearstone, TA Associates, and March Capital's combined total exit from BillDesk for US$4.7 billion to PayU, Warburg Pincus' US$1.2 billion exit from Encora, True North and TA Associates' US$1.2 billion combined exit from Atria Convergence Technologies.

PE investors in 2021 have continued to prefer buyouts and control deals, with a renewed focus on late-stage and growth equity investments. Upside sharing arrangements and management incentives are also gaining momentum, including in public mergers and acquisitions (M&A) – with most cases being approved by public shareholders. 2021 also witnessed continued usage of convertible securities (preference shares and warrants for fundraises) in public and private M&A, with the conversion linked to projected revenues with ratchets (especially in high growth sectors). Considering the volatility of new age stock listings, conversion ratios are factoring in IPO discounting and IPO failure penalties.

The IT and IT-enabled services sectors secured the largest share of PE investments in 2021, witnessing around 830 deals and a little more than 40 per cent of the total investments at US$40.7 billion. Banking, financial services and insurance companies were a distant second with investments totalling US$4.7 billion. Sequoia Capital India led the pack among investors with 107 investments. Foreign PE funds contributed 53 per cent of the deal value and 21 per cent of the volume.

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Jurisdictions

Australia	Ashurst LLP
Austria	Schindler Attorneys
British Virgin Islands	Appleby
Cayman Islands	Stuarts Walker Hersant Humphries
France	White & Case LLP
Germany	POELLATH
India	Khaitan & Co
Japan	Nishimura & Asahi
Mexico	Deloitte Legal
Nigeria	Streamsowers & Köhn
Russia	Dechert LLP
South Korea	Bae, Kim & Lee LLC
Spain	Cases & Lacambra
Switzerland	Niederer Kraft Frey
Thailand	Nishimura & Asahi
Turkey	Turunç
United Kingdom	Simpson Thacher & Bartlett LLP
USA	Simpson Thacher & Bartlett LLP