Navigating challenging waters

India has moved to attract more debt capital. But lingering legal issues mean that these investments need careful structuring

Exchange controls and the enforcement landscape in India have historically discouraged international investors from investing pure debt capital in the country. However, both the Reserve Bank of India (RBI) and the government have been keen to develop the debt capital markets in India and now have a better appreciation of the role of private capital in removing corporate debt from banking balance sheets. Consequently, the market has evolved and debt funds are now able to achieve pure debt exposure in relation to Indian companies (rather than investing in hybrid instruments). Private equity funds are also now able to move away from taking pure equity risk and can achieve some downside protection by structuring their investments. However, despite these positive changes, India still presents a challenging environment for first-time investors. The key issues and choices for international funds are summarised below.

Onshore v. offshore investment

A number of variables affect structuring choices for international investors including the ability to enforce security and transfer the capital outside of India, the location of key assets, exchange rate risk, price and return expectations and tax considerations.

Offshore structures

One initial issue for an international investor to consider is whether to invest in India or outside the country at a holding company level. Ordinarily, most investors would want to be as close to the operating assets as possible to create structural seniority and to minimise tax leakage. However, many investors choose to invest outside India as the returns are dollar denominated, removing the exchange rate risk on the return. Investors will still need to consider whether the operating business, with rupee denominated revenues, can service dollar denominated debt. Also offshore investments will, in most cases, be outside the scope of India's restrictive exchange control laws. Finally, security enforcement outside India (in relation to overseas assets) is seen as being more desirable than the lengthy process in India.

Despite these advantages, an offshore structure will only be feasible if there is an existing offshore holding company in place with sufficient assets and capital. Inserting a new holding company above an existing Indian business will not be tax efficient and there will also be exchange control issues to consider.

> **NCDs and masala bonds issued to international investors must have a three-year minimum maturity period**

To the extent that any lending to an overseas holding company is secured by share pledges over underlying Indian subsidiaries, Indian exchange controls restrict the funds from flowing into India. Therefore, such a structure will not be appropriate if the purpose of the investment is to directly fund Indian operations. In addition, investors that are not banks will need to seek RBI approval for such security (such approval is normally forthcoming).

Takeover Regulation issues

If the overseas borrower holds shares in a listed company in India, the investor will need to consider the Securities and Exchange Board of India (Sebi) (Substantial Acquisition of Shares and Takeover) Regulations, 2011 (the Takeover Regulations). If an event of default leads to a change of control of a target/borrower outside India, it will also trigger a mandatory tender offer for the Indian listed subsidiary under regulation 5 of the Takeover Regulations (which applies to indirect acquisitions of control). Apart from the cost of funding an acquisition, there are some difficult technical issues. The offer must be for at least 26% of the voting securities, but cannot result in the acquirer holding more than 75% of the voting securities (because of Indian public float requirements). Very often, the Indian promoters' overseas holding companies hold nearly all of the non-public float of their Indian listed company subsidiaries. Consequently, a mandatory offer is likely to result in a breach of the 75% cap. In those circumstances, regulation 7(4) of the Takeover Regulations will require the investor to subsequently sell down to satisfy the 25% public float threshold. A de-listing and minority squeeze out, although theoretically possible, is unlikely to be a practical solution in this context as it involves a separate process (which can be combined with the mandatory offer) and its requirements are difficult to satisfy.

The Takeover Regulations also restrict the acquisition or purchase of shares, voting rights, or control over a listed Indian company until the expiry of the offer period. This will affect the acquisition of control of a holding company by an investor exercising its rights upon an event of default. Some investors may choose not to exercise their control rights upon an event of default, but to enforce a local share pledge over a listed company instead. This also gives rise to difficult regulatory issues. The enforcement of a share pledge is arguably not an acquisition or purchase of shares, but the concern is, when tested, whether Sebi will view it in this way. Investors are understandably hesitant to take Sebi enforcement risk. Therefore, international investors should consider some of the partial workarounds that have evolved in this regard.

Onshore structuring in India

If the investor is unable to invest offshore or determines that it would be more appropriate to invest onshore in India, there are a number of regulatory issues that it will need to consider.

Permitted investments

Historically, private equity investors were required to take pure equity risk as they were only permitted to invest in shares or instruments that were mandatorily

convertible into the equity of Indian companies. There has been some easing of the regulatory position in this regard. By securing a foreign portfolio investor (FPI) registration (a relatively straightforward process), international investors can now invest in listed bonds known as non-convertible debentures (NCDs). In addition, the RBI now allows Indian companies to issue rupee denominated bonds outside India known as masala bonds.

Benefits for PE and debt investors

These instruments allow private equity investors to achieve downside protection and a guaranteed return on the capital invested in NCDs. Of course, any guaranteed return on the equity component of an investment will still not be permitted.

The other advantage for private equity investors is that, if properly structured, these instruments can be more efficient as far as distributions are concerned. Dividends suffer 20.34% tax leakage (which cannot be mitigated by tax treaty benefits), whereas interest benefits from lower withholding tax under various tax treaties (and NCDs currently benefit from a low tax rate on interest in any event).

As far as international debt investors are concerned, such instruments provide pure debt exposure, without any requirement for them to be converted into equity. Recent changes introduced in August 2016 have also made some of these instruments attractive from an enforcement perspective. Listed debt securities (listed under Sebi's rules) are now able to benefit from the enhanced enforcement procedures under the Securitisation and Reconstruction of Financial Assets and the Enforcement of Security Interest Act, 2002 (Sarfaesi). These procedures are seen as desirable by investors because they allow for the enforcement of security interests without court intervention.

Minimum maturity requirement

There is another point of note for foreign investors. NCDs and masala bonds that are issued to international investors must have a three-year minimum maturity period. This is not a lock-in obligation and this requirement does not apply to domestic investors. Therefore, an early exit will depend on the existence of a domestic secondary market for these securities (masala bonds cannot be held by residents in India, so this approach will not apply to them).

Aggregation of distressed debt through ARCs

Apart from structured investments, the aggregation of distressed debt has been the subject of considerable interest from a number of international special situations funds. Distressed debt here refers to debt that is overdue beyond certain RBI prescribed repayment periods. By way of background, the RBI requires banks to classify loans into various categories depending on how delinquent they are. Loans that are overdue more than 60 days are known as SMA-2 accounts and loans that are more than 90 days' overdue are known as non-performing. Distressed loans normally refer to these categories of debt. International investors can invest in this distressed debt through certain RBI registered aggregation vehicles known as asset reconstruction companies (ARCs).

Enforcement benefits of ARCs

Historically, ARCs have been attractive to international investors as they benefit from the security enforcement procedures under Sarfaesi, including the ability to enforce security without court approval.

However, Sarfaesi was amended in August 2016 to extend some of the enforcement benefits to Sebi-listed debt instruments. Therefore, an investor will need to consider whether an ARC is appropriate to its strategic needs. If an international investor's objective is to simply gain exposure to a slice of debt in the capital of a leveraged company, then a simpler approach would be to acquire debt securities that qualify for Sarfaesi benefits. Upon an event of default, the debenture trustee of these debt securities can trigger the enforcement proceedings under Sarfaesi without waiting for the lapse of further notice periods. In contrast, ARCs are subject to a slightly slower process, where the debt is required to be declared non-performing and a further 60-day notice period will need to be given to the borrower before these proceedings can commence. On the other hand, certain ARCs will be able to benefit from the strategic debt restructuring debt-to-equity swap scheme introduced by the RBI (this particular form of swap is not available to normal FPI bondholders). Therefore, ARCs are more suitable for longer term debt aggregation where the intention is to restructure a distressed company or to trade in distressed debt.

International investor participation

For those investors wishing to participate in ARCs, India's foreign direct ownership rules now permit foreign investors to acquire 100% of the share capital issued by ARCs. Therefore, there is no need to enter into joint venture arrangements with local partners, although some investors have chosen to do so to benefit from the local experience of their partners and because their local partners will be able to discharge the significant debt monitoring, restructuring and administrative requirements.

The normal investment structure involves a security trust acquiring the distressed debt from the banks and issuing rated security receipts to investors. The ARC manages the security trust and charges the security trust a fee (there are RBI regulations on the fees that can be charged). In addition, the RBI requires the ARC to subscribe for 15% of security receipts issued (the remaining security receipts can be issued to other foreign investors who have FPI registrations).

Other issues

In relation to the ability of the ARCs to leverage or syndicate their exposure, although ARCs could in theory issue NCDs to foreign portfolio investors, these ARCs will need to consider to what extent this will be consistent with the RBI requirement of their holding 15% of the security receipts as skin in the game. This will impose practical constraints on the ability of the investor to syndicate its ARC exposure.

Further, there is another technical issue which affects the transfer of the security receipts. One of the RBI's key exchange control regulations suggests that for non-primary acquisitions, FPIs can only participate if the security receipts are listed. There is currently no Sebi mechanism to list the security receipts. In addition, in September 2016, Sebi eased certain other stock broker transaction requirements for certain FPIs, so this seems to be a regulatory oversight.

Restructuring plans and realising value

As far as the enforcement of security is concerned, India remains a challenging jurisdiction. A summary of the main techniques commonly used in India as well as those used more rarely are set out below.

Traditional methods

Share pledges are commonly used in India. Particularly, if the shares are dematerialised (*ie* un-certificated and held through a depositary), the process for creating and enforcing security over the pledge is straightforward as far as unlisted companies

are concerned. However, share pledges involving listed securities are more difficult to enforce as discussed above. Additionally, the Indian Contract Act 1872 requires reasonable notice to be given to the pledgor as a pre-enforcement step (regardless of whether or not the shares are listed).

In relation to the enforcement of other security, much depends on whether the enhanced proceedings under Sarfaesi are available as these obviate the need for any court approval. Whilst it is helpful for investors to have these enforcement tools to hand, experience in undertaking successful Sarfaesi sales are mixed – on March 23 2016, the Bombay High Court set aside a Sarfaesi enforcement sale in *Blue Coast Hotels Limited v. IFCI Limited*. In addition, the RBI has indicated that it does not favour asset stripping by ARCs and sees their role as working together with management. Finally, once the Insolvency and Bankruptcy Code 2016 comes into force, companies undergoing an insolvency resolution process will be subject to a moratorium which restricts Sarfaesi rights.

Debt-to-equity swaps are commonly achieved through the issuance of convertible instruments to investors. In addition, those ARCs that are part of a joint lender forum will also be able to benefit from a regulatory swap scheme known as strategic debt restructuring introduced by the RBI.

In addition to the creation of security interests, investors sometimes improve their position through contractual protections. These include non-disposal undertakings, supplementing share pledges, where the borrower contractually undertakes not to sell shares of its subsidiaries, and cash-flow based protections in the form of escrow accounts, where the instructions call for restrictions on cash outflows in certain default circumstances.

Less common techniques

Some other aggressive investor techniques that are used in other jurisdictions are less common in India, because these are less likely to be successful in the Indian context.

With regard to management control, some investors structure their investments to include both equity and debt so that they have voting power to supplement their lender protections. ARCs and debenture trustees of Sarfaesi-compliant listed debt securities can also utilise the process under sections 9 and 13(4) of Sarfaesi to replace management. However, section 15(4) imposes an obligation on the investor to then restore the previous management once the debt is realised. This provision deters investors from using this specific statutory power. More generally, investors rarely seek to change management in India, as it is difficult to undertake any meaningful restructuring in India without the assistance of the controlling shareholder and its management. Also, investors may not have the ability to operate the companies and finding new management is not straightforward. The more common approach is to align controlling shareholder and management incentives in other ways.

India's foreign direct ownership rules now permit foreign investors to acquire 100% of the equity of ARCs

Credit bidding is uncommon in India, although there have been some examples involving real estate assets. This is not due to any particular regulatory constraint, but because the distressed market is still evolving. section 13(5A) of Sarfaesi does contemplate credit bidding in relation to immovable property in cases where the original bid has failed (because there were no bids at the reserve price). By implication, this may make credit bidding for immovable property under Sarfaesi more challenging in other circumstances (*ie* as part of the original bidding process). If this is a creditor's intention, then as a tactical matter it may wish to consider whether or not to enforce under Sarfaesi. The investor will also need to ensure that the valuation is fair, with a supporting independent valuation report and other measures to document the fact that there has been no collusion (a concern highlighted in the *Blue Coast Hotels* case), and also to satisfy exchange control and tax issues in India.

The use of fulcrum securities is very rare in India although there are some theoretical avenues to achieve this. For example, under the new Bankruptcy and Insolvency Code 2015, a creditor plan has to be approved by 75% (by value) of all creditors, whether secured or unsecured. This may create an opportunity for a creditor to block a plan. Also, separately, when the debt profile of a borrower hits certain trigger points, it is referred to an arrangement known as a Joint Lenders' Forum in which certain ARCs are also able to participate. Corrective action plans are to be approved by 75% by value and 50% by number of the Joint Lenders' Forum members. In theory, this also creates opportunity for an ARC to exercise its leverage. However, this sort of action has historically been uncommon in India. Investors normally seek to keep the other lenders and the controlling shareholder 'on-side' because any meaningful corporate action will require their support.

Critical factors

Structured private equity and special situations investments are currently buzzwords in India and both are attracting considerable interest from international funds. Although they each constitute different investment styles, the same regulatory framework applies to both of them. Also, given the highly leveraged position of a number of Indian business groups, the boundaries between the two are often blurred. There are three common critical success factors for international funds in relation to both types of investment.

First, the scope of what is possible is still limited and a number of techniques used in western jurisdictions are still constrained. Therefore, investors would be well advised to spend time understanding the regulatory environment and mapping this against their objectives and risk-adjusted return expectations to determine whether investing in India meets their needs.

Second, effective structuring is critical. Simplicity is the key, and investors are well advised to adopt a prudent approach to the interpretation of regulations in India and to sense test what is really possible. Investors should also recognise that it will be difficult to fully mitigate all risk. Therefore, investing in India implies taking on some emerging market risk.

Finally, management and ownership are rarely separated in India. Therefore, having a good understanding of the promoter is critical and there is no substitute for robust legal, commercial, financial and reputational diligence.

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