

Funds Hotline

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PRIVATE EQUITY IN 2014: LESSONS LEARNT AND EXPECTATIONS IN 2015!

Just as we gear up to the 'transformational' Budget 2015 as promised by the Modi Government, we bring to you a crisp summary of how private equity ("PE") performed in 2014, what were the lessons learnt and what lies ahead.

India witnessed an increase in the number and size of PE investments made in 2014 aggregating to around \$11.5 billion, which is 17% higher in terms of the total investment value as compared to the same period last year¹. E-commerce (led by Flipkart with two major rounds of funding)² followed by financial services, power and energy and engineering drove most of the activity with renewed interest in real estate sector as well. In the past years, exit routes have always remained one of the key deterrents for investors to invest into India, however last year we saw as many as 221 exits (including part-exit tranches) amounting to around \$3.8 billion³. Following are some of transaction trends / issues that gained significance in 2014, and which may be talked about more in 2015:

1. Withholding taxes

Notwithstanding the fact that the seller was an eligible tax resident of Mauritius or Singapore or other treaty jurisdiction, buyers in almost all secondary transactions insisted on withholding full capital gains taxes, and typically negotiated for a host of alternatives such as NIL withholding certificate, tax escrow, tax insurance, tax opinions and specific tax indemnities. With tax insurance not being available in all cases, deals were seen being done typically on the back of tax opinion and tax indemnity. Please see our article on such [safeguards](#). With Cyprus notified as a non-cooperative jurisdiction under Section 94A of the Income Tax Act, we saw increased applications being made to tax authorities under Section 197 of the IT Act for nil withholding.

2. General Anti-Avoidance Rules ("GAAR")

Though the government has promised to provide tax predictability, GAAR continues to remain a concern. Please [click here](#) for our detailed article on GAAR. Even in 2015, though there are strong indications that GAAR may be deferred, the ability of the tax department to bring any income generating from impermissible avoidance arrangements post August 30, 2010 may remain a concern.

3. Companies Act, 2013

2014 also saw the implications of the new Companies Act, 2013 ("2013 Act") replacing the Companies Act 1956 ("1956 Act") as majority of provisions of the 2013 Act were notified only in 2014. As of this date, 1956 Act has not been completely repealed and some of the major portions continue to be in force along with the provisions of the 2013 Act. We have analysed the changes brought in by the 2013 Act in detail, please [click here](#) for our analysis. Some of the important provisions of the 2013 Act which gained significance last year are:

■ Directors' liability

For the first time ever, the duties of the directors have been codified and a monetary punishment has been prescribed in case the directors act in contravention of their prescribed duties. Further, under the 2013 Act, any director who becomes 'aware' of any contravention of the provisions of the 2013 Act by way of his participation in the board meeting or receipt of information under any proceedings etc. but does not object to such contravention is termed as an officer in default and the concerned director is subject to the punishment prescribed under the 2013 Act. Such liability also extends to the non-executive directors in addition to the executive directors. Notification of these provisions last year made the investors re-think about the board position, and many investors in practice appointed an observer even when they had a right to appoint a director. Directors and Officers Liability Insurance (D&O Insurance) was seen as a necessity, even though in some cases such insurance has been found to be inadequate.

■ Insider trading

Insider trading provisions do exist for listed companies and very recently the Securities Exchange Board of India ("SEBI") has notified the new regulations (please [click here](#) to read our analysis on the same). However, the 2013 Act has also introduced an insider trading provision, which in addition to public listed companies, also applies to unlisted companies (whether public or private). Please [click here](#) for our article on the new insider trading regulations.

■ Voting arrangements

Under 1956 Act, concept of different classes of shares i.e. equity shares and preference shares was not applicable to private companies, and hence such companies were allowed to issue shares (whether equity or preference) with differential rights. For instance, preference shares with voting rights on as if converted basis, etc. However under the 2013 Act, (i) the provision relating to different classes of shares has been made applicable to both private and public companies; (ii) no separate exemption has been provided to private companies for the issuance of shares

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(whether equity or preference) with differential rights; and (iii) it has been specifically provided that preference shares cannot have voting rights; therefore, private companies now cannot issue preference shares with voting rights. Since, preference shares continue to be the preferred instrument of investment because of certain other benefits such as better enforcement of anti-dilution and liquidation preference, we have seen more voting rights arrangements being entered into between the shareholders, to give effect to the commercials.

4. Representation and Warranties Insurance (“R&W Insurance”)

R&W insurance gained popularity in 2014, especially in secondaries between PE players. Since in such deals, (i) the original promoter or the company may not directly benefit, (ii) the selling investor is typically not involved in the day to day management of the company, and (iii) the selling investor is not in a position to give business related warranties, R&W Insurance was seen as an important risk and liability mitigation tool at a rather reasonable premium. This also is the case, where the fund life of the selling investor is going to end soon. The costs for such R&W Insurance could be borne completely by the seller, or shared between the buyer and the seller. In cases where the promoter may not have the financial wherewithal to honor his / its representations and warranties, R&W Insurance offered an ideal prospect in deal making.

5. Structured debt transactions

Structured debt, mostly listed non-convertible debentures with payable-when-able structures or variable-linked-coupon structures gained credence in 2014 as well. Such structures were also seen in promoter funding structures where the promoter entity issues structured debt to acquire shares in their listed company with the return on these debt instruments linked to performance of the listed stock with some downside protection. As these are debt instruments, PE investors derived comfort from: (i) guaranteed returns plus equity upside depending upon the company's EBITDA, stock prices, cash flows, etc.; and (ii) security creation in the form of mortgage, pledge, guarantee etc. For the promoters, such instruments offered tax optimization without equity dilution. Please [click here](#) for our research paper on 'Private Equity and Private Debt Investments in India' for a more detailed analysis.

6. RBI's timeline for regulatory approval

In July last year, RBI came out with certain timelines for different kinds of regulatory approvals. Under these timelines, RBI has made its departments answerable in case they exceed the prescribed timeline. The investor community and other stakeholders have always been apprehensive about approaching any regulatory body for any approval and therefore the transactions were typically structured in a way to avoid the requirement of any approvals, at times, by even letting go of certain rights. This was because, in most cases, the regulatory bodies instead of opining on the application would just hold on, leading to unnecessary delays in the project. But now with the RBI's 'Timelines for Regulatory Approvals', the stakeholders would have more certainty from a timeline perspective, and hence they will be more forthcoming in approaching them for the approvals.

7. Shareholder activism

Shareholder activism has slowly gathered pace in India. Several big conglomerates last year faced the ire of minority shareholders who rejected their various resolutions like setting up of a subsidiary company, related party transactions, increase in the remuneration of the top executives, disposal of an undertaking etc.⁴ Some reports suggest that the instances of shareholder activism in India are highest in Asia.⁵ Advent of shareholder activism in India is a welcome change and is being appreciated by global investors as it brings transparency in the system and also helps the minority shareholders to raise their concerns directly with the top management of the company. It also ensures that the interest of the various investors, be it small retail investors or an institutional investor is safeguarded at all times and the companies provide detailed rationale for each resolution proposed and also to address the perceptual issues as well. While shareholder activism may bring in more transparency into the system, if misused it can also lead to hampering of the decision making process in the company.

8. Diligence

2014 witnessed investors conducting more stringent background checks on the promoters and key managerial personnel. Forensic audits and anti-corruption / anti-bribery compliances gained increased importance⁶.

9. Entry and exit facilitation

RBI relaxed the DCF based pricing for entry and exits to a more liberal internationally accepted pricing methodology.

Put options (common mode of exit in certain asset classes like real estate) were legitimized⁷. Capital account controls were also relaxed to allow for partly paid shares and warrants, which were quite helpful in structuring foreign investments within the convoluted and stringent Indian regulatory framework.

10. Externalisation

Externalization, or setting up of offshore holding companies for Indian assets, continued to attract both private equity players and their portfolio companies, especially in the tech space. Some of the major reasons for doing so include tax benefits at the time of exit, avoiding Indian exchange control issues, mitigating currency fluctuation risk, better enforceability of rights, etc. For a more detailed analysis on 'externalisation', please [click here](#).

11. Depository Receipts (“DRs”)

Ministry of Finance allowed issuance of ADRs / GDRs both sponsored and unsponsored by unlisted companies in India. For further details on the new depository receipt regulation, please [click here](#). This allowed for Indian companies to tap global capital markets without first going public in India considering that only a handful of Indian companies went public in 2014. DRs also allow a tax optimized entry and exit route for private equity to invest in Indian companies, please [click here](#) for analysis. Please [click here](#) to refer to our article on the benefits of issuing DRs.

CONCLUSION

Year 2015 started off with Sensex zooming to an all-time high level, reduction in the lending rates by RBI, controlled inflation, certainty of achieving fiscal targets, RBI allowing an India conglomerate group to give a pre-decided downside protection on equity shares which is reportedly more than 2 times the existing fair market value of the equity shares. All these factors will certainly improve the image of India in the eyes of the international investors. However, there remain certain issues/demands which if accommodated in the Budget 2015 will boost the PE investments in India, such as:

1. **MAT**: Government should exclude Special Economic Zones (SEZ) and transfers to real estate investment trusts (REITs) from the purview of minimum alternate tax (“**MAT**”). Even for other sectors the rate at which MAT is imposed should be reduced to around 10%.

2. *Tax Pass Through:* Tax pass through should be provided to all the alternative investment funds, and not just Venture Capital Funds. This should not result in any tax leakage for the revenue since anyways either the trust or its beneficiaries can be taxed, but will go a long way in giving tax predictability to investors.
3. *Creating vibrant public markets:* Institutional play in bourses needs to be encouraged, and for that purpose restrictions on insurance companies and pension funds on capital markets exposure need to be relooked at.
4. *Defer and Rationalize GAAR:* While there are reports that the Government is contemplating to defer GAAR, the government should more importantly focus on certainty, fairness and stability in the implementation of GAAR.
5. *FVCI Investment:* FVCIs should be permitted to invest in all sectors (except the current negative list), rather than the current nine sectors that FVCIs are eligible to invest in.
6. *Transfer Taxes:* In order to ensure ease of exit, revenue should provide tax certainty on both direct and indirect transfers. On direct transfers, there should be certainty to tax treaty entitlement and attendant capital gains treatment. Such certainty will allay the unnecessary costs of tax insurance and make transfers of Indian assets easier. From an indirect transfer (Vodafone case) perspective, the government should clearly define the scope and extent of the terms such as “transfer”, “interest”, “substantially” in the context of indirect transfers, and accept Shome Committee’s recommendation that the term ‘substantially’ should mean that atleast 50% of the value of the overseas entity derives its value from Indian assets.

– Dipanshu Singhal, Deepak Jodhani & Ruchir Sinha
You can direct your queries or comments to the authors

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- ¹ <http://myiris.com/news/economy/private-equity-investments-is-positive-in-2015-pwc-india/20141223140914199>
 - ² <http://www.vccircle.com/news/general/2014/12/31/top-pe-deals>
 - ³ <http://www.vccircle.com/news/general/2014/12/31/top-pe-exits>
 - ⁴ <http://www.ft.com/cms/s/0/3f0aa396-7ba7-11e4-b6ab-00144feabdc0.html#axzz3OaSRBnji>
 - ⁵ http://www.business-standard.com/article/markets/shareholder-activism-in-india-highest-in-asia-says-report-114092300620_1.html
 - ⁶ http://articles.economictimes.indiatimes.com/2015-01-07/news/57791855_1_india-fraud-survey-j-sagar-associates-uk-bribery-act
 - ⁷ <https://nishithdesai.com/SectionCategory/33/Funds-Hotline/12/40/FundsHotline/5176/1.html>
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