Riding solo

As Hero and Honda part company after 26 years, *India Business Law Journal* discovers that dismantling an old deal can be as complex as putting together a new one

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It was one of the success stories of India's first wave of economic reforms. Yet on 22 March, Hero and Honda walked away from a long-standing marriage that helped redefine the country's automotive industry.

Hero, the Indian partner in the relationship, traces its roots back to 1944 when four brothers set up a business making bicycle parts. In 1956 the brothers – Satyanand, Om Prakash, Dayanand and Raman Kant Munjal – started a new business called Hero Cycles to manufacture complete bicycles.

The company went from strength to strength. By 1975, Hero had become India's leading bicycle manufacturer and in 1986 it was cited in the *Guinness Book of Records* as the largest bicycle manufacturer in the world.

In 1984 Hero signed a pioneering agreement with Honda to establish Hero Honda Motors, a joint venture to manufacture motorcycles in India based on Japanese technology. The agreement was signed in the presence of then-prime minister Indira Gandhi.

Honda and the Munjal family each took 26% of the shares in the joint venture, with the remainder being publicly held. The Munjal family's stake was held through various affiliate companies, notably Hero Investments Private Limited (HIPL), which took a 17.33% stake in Hero Honda.

King of the road

The partnership was a considerable success and by 2001 Hero Honda had become the world's largest manufacturer of two-wheeled vehicles. Sales reached around US$3.6 billion in the 2009/10 financial year and the joint venture accounted for almost 50% of India's domestic motorcycle market.

But as creeping economic liberalization increased the opportunities for foreign companies to go it alone, Honda grew restless in its marriage. The Japanese company began to crave the freedom to explore India on its own.

In 1999 it set up a wholly owned subsidiary called Honda Motorcycle & Scooter India. Armed with a wealth of experience gained from its joint venture, Honda Motorcycle successfully entered the domestic market, selling products branded solely with the Honda marque.

Hero, meanwhile, had unfulfilled dreams of its own. It aspired to enter lucrative export markets, but was prevented from doing that by the terms of its joint venture agreement with Honda.

Disentangling assets

In late 2010, Hero and Honda announced plans to separate. The two companies described the dissolution of their 26-year marriage as an "equity realignment" and confirmed that Hero Honda will be permitted to use Honda's name until 2014. It will also continue to receive new technology from the Japanese company in exchange for royalty payments.

A joint press release by the companies said that "the decision to restructure the equity had been reached in a very cordial and amicable manner". Yet the deal was shrouded in secrecy and the price that Hero was paying to purchase Honda's shares was not disclosed.

A month later, on 24 January, the two partners signed a binding licensing agreement covering their existing products as well as any new products that they would launch in India. Hero was given the freedom to export its products and to

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Founding partner
Finsec Law Advisers

develop its own research and development capabilities, privileges it had been denied under the joint venture.

J Sagar Associates advised Hero on the separation. It deployed a five-member team on the deal that included founding partner Jyoti Sagar and partner Venkatesh Prasad.

Honda was represented by Khaitan & Co, with director Ketan Kothari assuming the role of lead adviser. The law firm counselled Honda on matters relating to the transaction documents, the compliance of conditions precedent, the Takeover Code, various exchange control issues and foreign direct investment policy.

Soichiro Uno, a partner at Tokyo-based law firm Nagashima Ohno & Tsunematsu, was Honda's Japanese counsel.

Financial surprise

On 8 March, the companies finally disclosed the financial arrangements behind their separation.

To the surprise of many, Honda had agreed to sell its 26% stake in Hero Honda to the Munjal family for just US$854 million – less than half its current value. Industry observers were abuzz with speculation and many expressed concerns that Hero Honda would be required to make higher than expected royalty payments to compensate Honda for the cheap sale price.

"[Honda has no reason] to sell out at a significant discount to the market price," says Siddharth Shah, who heads the corporate and securities practice at Nishith Desai Associates in Mumbai. "As per some reports, the difference is likely to be compensated in terms of increased royalties because their technical collaboration is still going to continue beyond the termination of the shareholders' agreement."

Hero Honda officials have been hard pressed to explain the pricing discrepancy, but deny rumours that Honda will receive compensation through abnormally high royalty payments. "There are concerns, but it's a negotiated price between two promoters ... it's the formula that had been worked out for long and the discount has no link to the current share price of Hero Honda," Hero Honda's chief financial officer, Ravi Sud, told the *Economic Times*.

Pawan Munjal, the company's managing director, told the media that Hero Honda's royalty payments would gradually decline. Sud, meanwhile, said that Hero Honda will pay Honda a lump sum every year, irrespective of sales or model mix. "Even if our sales increase by 15-25%, our maximum royalty would be under 3% on an annual basis," he said.

Hero Honda's existing royalty payment to Honda is 2.5% of its annual sales.

Deviating from the norm

For deals of this nature, deviating from the prevailing market price is not uncommon. In 2008 Japan's Daiichi Sankyo bought a stake in Indian pharmaceutical company Ranbaxy at a premium of 30%. A year earlier, India's Sun Pharmaceuticals paid a 27% premium to acquire a controlling stake in Israel's Taro Pharmaceuticals.

According to Sandeep Parekh, the founding partner of Finsec Law Advisers and a former executive director of the Securities and Exchange Board of India, Indian companies typically sell stakes to foreign investors at more than the market price, but pay less than market price when acquiring them. In this case, however, Parekh believes "the discount is too big to be considered normal".

Approvals for new investment

To finance the acquisition of Honda's shares, Hero's HIPL affiliate turned to private equity investors. Deals were struck with two funds – BC India Private Investors II, an affiliate of Bain Capital, and Lathe Investment, a wholly owned subsidiary of Government of Singapore Investment Corporation (GIC) – both of which agreed to provide finance for the deal in return for shares in HIPL.

Anil Kasturi, a partner at AZB & Partners, is representing Bain, while GIC is being advised by Desai & Diwanji. The firm's lawyers working on the deal include partners Vishwang Desai and Vihang Virkar and associate partner Shyam Pandya.

HIPL did not disclose the amount it was to receive from the private equity funds, nor the number of shares that they would be given in return. However, any investment from a foreign entity that exceeds ₹12 billion (US$270 million) requires special clearance from the Cabinet Committee of Economic Affairs in addition to the regular approval by the Foreign Investment Promotion Board. A government communiqué confirmed that HIPL sought clearance for a foreign investment of up to US$1 billion.

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Nishith Desai Associates

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Supreme Court Advocate

Cash flow glitch

The protracted approval process that resulted from the size of the investments presented a problem for HIPL. It could not accept the cash until formal approval had been granted, yet it needed the funds quickly in order to conclude the deal with Honda.

To bridge the gap, HIPL obtained short-term loans from Axis Trustee Services, IL&FS Trust and IDBI Trusteeship Services, in return for which it pledged most of its 17.33% shareholding in Hero Honda as security. The cash enabled it to purchase all of Honda's shares on 22 March.

The following week, on 29 March, approval was granted for HIPL to receive the investment from the private equity firms. The company said that the funds would "be used to retire a significant portion of the debt that has been raised by HIPL recently for financing the acquisition [of Honda's shares]".

Dodging the bullet

Meanwhile, another regulatory problem was looming on the horizon. HIPL's purchase of Honda's shares in Hero Honda had the potential to trigger the requirement for an open offer to be made under the terms of the Takeover Code.

To avoid this, Hero Honda successfully argued that the transfer of shares was between two co-promoters, and that the company was therefore exempt from this requirement.

The same issue could have arisen from the private equity investments in HIPL. Private equity is not exempt from the open offer rules, but as Shah at Nishith Desai Associates observes, an open offer was not called for. This indicates that neither private equity fund acquired a large enough stake in HIPL to cross the 15% threshold in Hero Honda.

Other regulatory apprehensions stemmed from the discounted price at which Honda's shares were sold and fears that this would violate the stock market's price discovery mechanism. "Execution of the trade on the market outside of the block trade window could be viewed as flouting the principle of free-price discovery, warranting a SEBI enquiry," says Shah. "It could also result in leakage as other stocks available at the time of sale would need to be mopped up."

Tax obligations

Possibly in anticipation of problems relating to the discounted price, Hero and Honda decided to conduct the equity sale outside the stock exchange. However, as a result of this decision, they lost the tax exemption that they would have enjoyed if the shares had been sold on a trading floor.

Honda, as the seller, has the most to lose. "The difference between the cost of acquisition of the share and the price of the consideration would be taxable and depending upon the bilateral tax treaty with Japan there would be an obligation to withhold tax," says Shah.

The withholding obligation rests with the purchaser. One observer who was closely involved in the deal confirmed to *India Business Law Journal* that Hero has already fulfilled this obligation. Regarding the wisdom of conducting the deal "off-market" despite the tax implications, the observer says, "one has to look at what is more feasible from a commercial standpoint for the transaction – tax efficiency or efficiency of implementation of the transaction".

Some lawyers caution that additional tax surprises may lie in store. For example, Homi Phiroze Ranina, a Supreme Court advocate, predicts that "there will be serious problems as tax authorities may say that capital gains tax will be assessed at the prevailing market price [as opposed to the actual sale price]."

Handle with care

Uncertainties such as this underscore the risks of doing deals in jurisdictions with complex tax regimes. "We have been in situations where parties have even purchased tax insurance to mitigate such risks depending on the uncertainty," says Shah. However, since there is no capital gains treaty benefit being claimed and gains would be subjected to tax in India, this could be a non-issue in this case, he adds.

But tax troubles are far from being the only complications that can arise during demergers. Ravi Nath, the managing partner of Rajinder Narain & Co and a director of Hero Honda, believes that in some ways, demergers are more complicated than mergers.

Nath highlights non-compete agreements, payment issues, the security that either party may provide and dispute resolution clauses outlining governing laws and jurisdictions as just some of the major hurdles that may arise when companies part ways. Other challenges relate to the use of the intellectual property, tools and any spare parts that may have been supplied by one party to the other.

With difficult considerations such as these behind him, Hero Honda's managing director, Pawan Munjal, is charting a new course for his company. He recently hired Wolff Olins, an international brand and innovation specialist, to create a new identity for Hero Honda, and in all likelihood, a new name.

Speculation will undoubtedly continue over the rationale for the low sale price and the decision to conduct the deal off-market, but the answers may never be disclosed. For rather than dwelling on the past, Munjal appears focused on planning the future.

"We are well poised to embark upon a new exciting journey," he says. And with his former joint venture partner becoming his primary competitor, he certainly looks set for an exhilarating ride.