PRIVATE EQUITY GROUP

Conducting Successful Transactions in India

What foreign investors need to know about doing deals in India

Dear Friends

Over the past several years India has become a strategic hub for Asian private equity. A host of factors make India an attractive private equity market: restructuring opportunities at attractive valuations, newly deregulated industries requiring capital and management inputs, a rich talent pool, corporate transparency, and a robust legal system. An increasing number of foreign investors are now joining the top tier global firms who are already pursuing private equity opportunities in India.

While the opportunities in India are immense, all investors must be aware that the business culture and practices in the country can differ substantially from what they are accustomed to at home—often leading to pitfalls for the unprepared. This report, Conducting Successful Transactions in India: What Foreign Investors Need to Know About Doing Deals in India, is designed to help foreign investors understand some of the key features of the Indian private equity environment. The report includes:

- A survey of the current Indian private equity landscape, including investment trends, exit opportunities and the growing business case for investing in India
- An overview of the impact of converting Indian portfolio company financials from India GAAP to US GAAP from an investor's perspective
- Key success factors for conducting effective due diligence in the Indian business environment
- Answers to the questions most frequently asked by foreign investors considering a transaction in India

We hope that this report will be a very useful resource for foreign investors as they approach opportunities in India. As India's leading service provider to the private equity industry, Ernst & Young offers market insight, industry experience and an array of transaction advisory services to assist foreign investors anywhere in the country.

We look forward to meeting you soon in this exciting time for private equity in India.

Sincerely,

Rajiv Memani
CEO & Country Managing Partner
Ernst & Young

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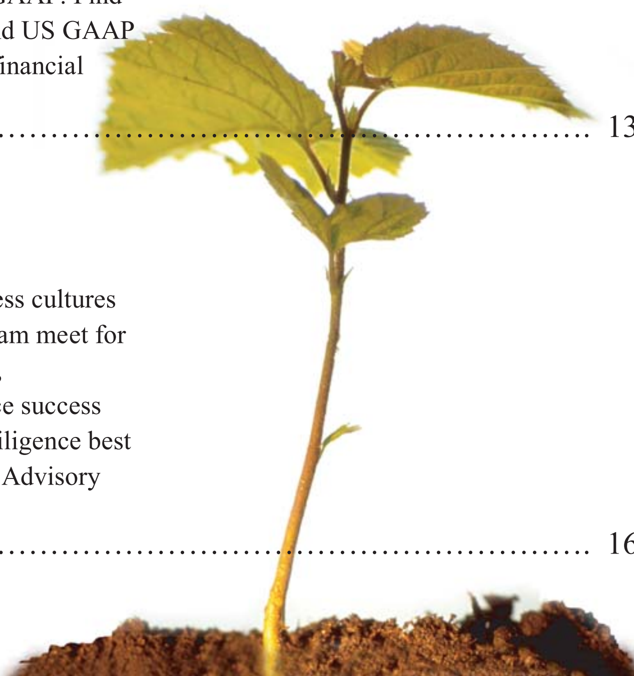


1 India : A Growing Private Equity Hub

Indian Private Equity and Venture Capital Industry

By Gagan Kapur

Introduction

The financial crisis of the late 90s in the Far East and the collapse of the internet bubble changed the Asian private equity industry forever. Valuations became more attractive, creating opportunities to buy good businesses at low prices and enhancing value through restructuring. India is an emerging entrepreneurial, skilled, competitive economy, positioned to be one of the world's greatest economic centers in the near future. India has recently been elevated to one of the region's strategic hubs and is undoubtedly one of the best picks for private equity investments. The factors that make India more investor friendly than other growth markets in this region are a well established corporate legal system, professional business culture, liquid capital markets, stable political system, use of English as the language of commerce and the availability of quality managers. At the same time, like many developing countries, India is a unique market with its own set of local flavours.

Let us look at some key trends and aspects of the Indian Private Equity (PE) industry.

What makes India an attractive PE proposition?

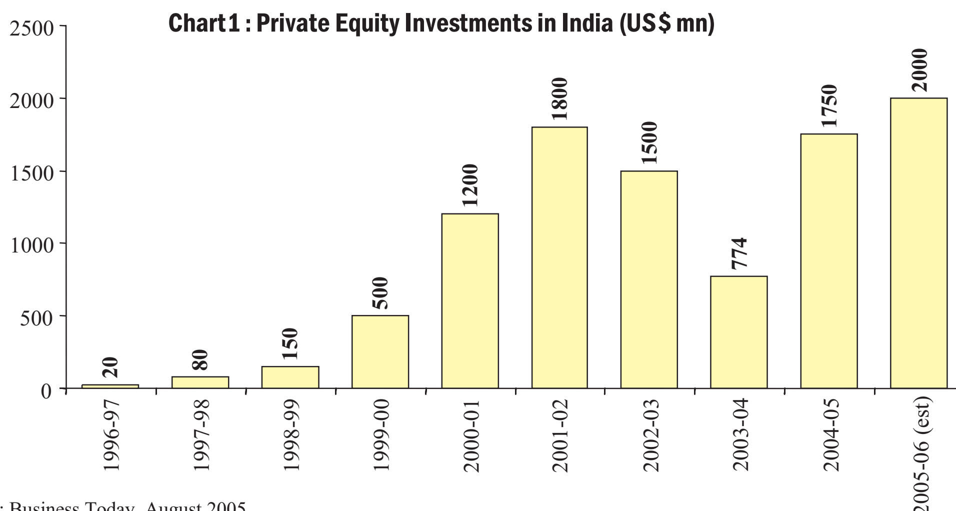
With a Gross Domestic Product (GDP) of US$600bn (Purchasing Power Parity adjusted US$3.1tr); India is the third largest Asian economy, also the second fastest growing in the region, next only to China. At an annual growth rate of 7-8%, it is surely ahead of many developing economies. A major contributor to this growth has been a buoyant services sector contributing more than 50% of the GDP. However domestic consumption, 65% of GDP, still forms the bedrock of this growth. We believe that exports led by IT& ITES will increasingly become the trigger for future sustainable economic growth.

The other factors in favor of India are:

- **Unmatched Demographic Profile:** With 54% of its population below 25 years of age, one fourth of the world's youth live here. Income distribution is going to see a structural shift with proportion of high income households set to multiply. Rising income levels, in addition to these factors is setting the stage for a consumer boom in India.
- **Reservoir of Intellectual Capital:** India has a vast pool of young professional talent, 23 million, including graduates, engineers, doctors which are increasing by nearly half a million every year. A meritocratic educational system with special focus on English, Science & Mathematics has contributed to building a quality intellect capital. No surprise then, India is a net exporter of talent.
- **Deregulation in key sectors:** The ruling government has successfully undertaken deregulation of key sectors viz. Telecom, Insurance & Retail. This has lead to an increased pace of activity in these sectors with foreign players eying to get a share of the Indian pie.

India is flush with PE funds

The market for Private Equity (PE) in India, virtually unheard of a decade ago, has grown from a mere US$ 20 mn in 1996 to US$1.75 bn in 2004. In the current year it is estimated to cross the US$ 2 bn mark.



Source: Business Today, August 2005

Table 1: Big Ticket PE Exits in 2005 — **Exits via M&A : Jan-Sept 2005**

Portfolio Co.	PE Investors	Sector	Acquirer	Deal Date	Deal Amount (US$ Mn)
Ambuja Cements India	AIG, GIC	Cement	Holcim	Jan-05	200 (for a 40% stake)
Indus-League Clothing	ICICI Ventures	Apparel	Pantaloon Industries	Jan-05	5.3 (for a 68% stake)
Vergil Technology	eVentures India	IT Services	American CyberSystems	Feb-05	NA
Rev IT Systems	UTI Ventures, TDA Capital	ITES	ICICI OneSource	Mar-05	NA
Momentum Technologies	CVC International	IT Services	Newell & Budge Group	Mar-05	NA
Arvind Brands	ICICI Ventures	Textiles (Branded Apparels)	Arvind Mills	Apr-05	24.7
Linc Software Services	ICF Ventures	IT Services	Mindtree Consulting	May-05	
Knowledge Systems	UTI Ventures	IT Services	Ciber	Jun-05	3.1
Intigma	EVentures India	Spend Data Management	Emptoris	Jun-05	
BPL	Actis, AIG	Mobile Telecom Services	Essar Group	July'05	1000 (for 64%)
i-flex Solutions	CVC International	Banking software	Oracle	July'05	593
Apollo Hospitals	Symphony Capital	Healthcare	Khazanah Nasional	Aug'05	44

In the first nine months of 2005 already 94 deals have been concluded with their value exceeding US$ 1.3 bn. An indication of the investment activity in the PE space can be guessed from the fact that in the past nine months over dozen funds have either been raised or are in the pipeline.

The PE industry has evolved both in terms of participants and type of deals. The average deal size in India more than doubled. From US$ 8 mn in 2002 it has gone up to US$ 18 mn in 2004. There has also been a shift from start-up and early stage funding towards late stage funding. In fact, the share of start-ups has dropped from 27% in terms of deal value in 2003 to 11% in 2004. While expansions and late stage financing dominated 2005, the new category of investments which is gaining prominence is private investment in public enterprises (PIPE) which also focuses predominantly on late stage deals. The share of PIPE deals has increased from 37% of total deal value in 2003 to 44% in 2004. In the first six months of 2005 too, they have accounted for the lion's share of the deals. One of the factors encouraging private equity investments is the rewarding exits achieved by the industry in the recent past. A robust economy, upbeat business confidence and the buoyant stock market heralded a season of healthy exits both through Initial Public

Table 1: Continued — **Exits via IPO : Jan-Sept 2005**

Portfolio Co.	PE Investors	Sector	Deal Date	Deal Amount (US$ Mn)
Gateway Distriparks	Temasek, IDFC	Logistics	Mar-05	35
UTV Software Communications	CDPQ	Media	Mar-05	20
Allsec Technologies	Kotak Mahindra, Eurindia	ITES	Apr-05	10
Shopper's Stop	ICICI Ventures, IL&FS VC	Retail	Apr-05	40
India Infoline	ICICI Ventures, Intel Capital, Actis, Kothari Pioneer, TDA Capital	Financial Services	Apr-05	22
YES Bank	CVC International, ChrysCapital, Russell Asian Infrastructure Fund	Banking	Jun-05	73
Nectar Lifesciences	CVC International	Pharmaceuticals	Jun-05	21
HT Media	Henderson, CIFC	Media & Entertainment	July'05	86
IL&FS Investmart	Softbank Asia Infrastrucure Fund	Financial Services	July'05	33
Sasken	Intel apital, Nokia Growth Partners, New Enterprise Associates	Communications	Aug'05	30

Source: Venture Intelligence India

Offering (IPO's) and Mergers & Acquisitions (M&As). Approximately, US$ 2.2 bn has been raised through exits from few of the top deals till September 2005. The virtuous cycle of investments and exits, coupled with the increasing FDI interest in India is encouraging both domestic and foreign PE firms alike to raise more funds for India. In the first nine months of 2005, there have already been 27 exits, of which 10 are through the IPO route. Whereas in the entire 12 month period of 2004, there were a total of 30 exits, of which six used IPOs. Actis' exits of UTI bank for US$ 35 mn in July 2004 and in IDFC for US$ 56 mn in July this year were the other big gainers. However the most prominent exit this year has been Warburg Pincus's exit in Bharti Televentures, where it turned a US$ 300 mn (invested between 1999 and 2001) into more than US$1.9 bn through sale in open market and to strategic investor (in four tranches) between August 2004, March 2005 and November 2005.

Private Equity Landscape

While the world has only recently started supplying capital to India, there are estimated to be 62 private equity players here. The number is only rising, 3i, The Blackstone Group, Texas Pacific Group and Carlyle's buyout fund are some of the new foreign entrants. Foreign buyout firms are arriving almost on a monthly basis, poaching experienced local managers and setting up shop in Mumbai, Bangalore and New Delhi – often working out of hotel suites, rather than wait to find suitable office space. The number of investors in the market is leading to stiff competition. Deal making is becoming expensive with rising valuation expectations.

The Indian market is flush with funds. A key factor is that founders have many alternate options for raising capital. With alternative sources of funds available in the market such as IPO, short-term private placement, Foreign Currency Convertible Bonds (FCCB) and even Global Depository Receipts (GDR's), founders have little to worry. At the same time, it isn't an easy market to operate in with deals being primarily relationship driven, complex regulations, some of the terms of co-ownership being unique to the country and a premium on quick turnarounds. Funds or fund managers with long experience of operating in the country often hold the upper hand. Intense competition is also resulting in a tighter segmentation of the PE market. Until 2004, it was one size fits all. Now, players like ICICI Ventures, IL&FS and ChrysCapital – who earlier also dabbled in early-stage investments – are focused on late-stage and PIPE deals.

Table 2: PE Fund Universe in India

S.No	Type of Fund	Description	Avg deal size	Funds operating in India
1	Fund of Funds	Funds that invest in Funds	large typically > $ 100 mn	Evolvence India Fund
2	Buyout Funds*	Funds that invest in entire businesses to gain operational control of the business, add value to it and then sell it at a premium	> $100 mn	New Bridge, Carlyle, Apax & Blackstone, ICICI Venture
3	Late-stage Private equity fund	They target large cap stocks	$30-100 mn	Warburg, Temasek, General Atlantic Partners & 3i
4	Mid market private equity funds	Invest in mid-cap stocks either listed or unlisted	$10-30 mn	CVC, ChrysCapital, Actis, Baring, GW Capital, Oak, Kotak, ILFS, IDFC
5	Venture Capital Funds	Invest in start-ups and early stage companies	upto $20 mn	WestBridge Capital Partners, ICICI Venture, JumpstartUP, UTI Ventures, IFC, Intel Capital, SIDBI
A new phenomena				
1	Real Estate Funds	Invest in Real Estate Projects		IREO, Ascendas India Property fund, OZ Capital, Trikona
2	Hybrid Hedge Funds	Invests in everything from private equity to corporate bonds		Oaktree Capital Mgmt, New Vernon Pequot Capital

Note : * Most of these funds inter change their focus between late stage and buy outs depending on the opportunity.

Source: Business Today, August 2005

Industries: Who Is the Fairest Of 'Em All

While some sectors such as IT&ITES, Life sciences, automotive, chemicals and textiles have been more attractive, deals are also touching traditional industries like metals, oil and sugar.

Top deals for 2005 (YTD):

1. The US$100 mn investment by Newbridge Capital in three truck financing firms belonging to the Chennai-based Shriram Group
2. The buyout of Associated Cement Companies' (ACC) refractory business by ICICI Ventures for about US$59.8 mn
3. US$46 mn investment by Warburg Pincus in publicly listed plastics and textile manufacturer Sintex Industries in return for 17% stake
4. US$45 mn invested by 3i in Nimbus Communications
5. US$45 mn investment by ICICI Ventures and CVC International in Perlecan Pharma
6. US$44 mn investments by IDFC, HDFC & IL&FS in Leela Hotels for a 18% stake
7. US$32.6 mn investments raised by ABG Shipyard from Merlion India Fund and IL&FS Investment Managers

Another interesting trend is that no longer are export focused companies the toast of PE investments. The booming Indian economy has led PE firms to also view domestic demand led sectors like financial services, construction, telecom, civil aviation, real estate and media & entertainment favorably. In the first nine months of 2005, the manufacturing (including automobile) sector and the IT & ITES sector topped in terms of number of deals (22% each of the total).

These sectors were followed by life sciences & healthcare, textiles & garments and media & entertainment.

The Sunrise Sectors

M&A, expansions & new ventures in these sectors will expand the scope of private equity.

- **Textiles:** Phasing of MFA from January 2005 will benefit Indian textile companies. India's share in the global textile trade is expected to rise to 15% from 4%.
- **Biotechnology/Pharmaceutical:** Indian patent laws are now compliant with TRIPS. With the era of process patents over, International pharma companies are seeking an Indian presence and invest in India as a manufacturing base. More PE deals can be expected as Indian pharma companies seek funds to invest in R&D.
- **Oil & Gas:** The hunt for energy security is driving increased activity in this sector with domestic companies seeking assured sources of supplies by entering into alliances abroad.

Table 3 : PE Favorites- How the Sectors Stack up (Jan-Sept 2005)

Top Sectors	No. of Deals	Value of deals (US $ mn)	Share by no. of deals	Share by deal value
Manufacturing (incl automobiles)	21	241	22%	18.38%
IT & ITES	21	190	22%	14.49%
Life sciences & Healthcare	13	199	14%	15.17%
Textiles & Garments	9	128	10%	9.76%
Media & Entertainment	7	100	7%	7.62%
Engg & Construction	6	123	6%	9.38%
BFSI	5	191	5%	14.56%
Hotels	3	60	3%	4.54%
Others	9	80	10%	6.10%
Total	**94**	**1,312**	**100%**	**100%**

Source : Venture Intelligence India

They're bidding for foreign oil sources, picking up stakes in oil fields and refineries. Under the new exploration and licensing policy, foreign companies are also allowed to invest in India.

- **Banking:** The sector expects to see further consolidation with the number of Indian banks already looking for acquisitions to expand their geographical presence both in India & abroad.
- **Telecom:** Revenues from this sector are expected to reach US$21 bn by 2008 from US$8.3 bn currently. The potential for growth is huge with teledensity still at a low of 7%. The broadband segment is also expect to see more activity in the coming days.

From Back Office to a dynamic R&D hub

Over the past two decades, India has become an information technology services powerhouse. Now it is moving up the value chain towards research and development services in not just IT, but a host of other sectors. More than 100 companies from around the world have set up their R&D centers in the country during the last five years.

Attempts are already underway to remove the roadblocks in India's path to becoming a global research hub. On intellectual property rights, the country is a signatory to the WTO. Availability of local talent is improving with hundreds of expatriate engineers and scientists returning to India. The low level of basic research is often cited as an obstacle, but this is slowly being overcome by increasing investments in R&D facilities. As per NASSCOM, for the year ending March 2005, revenues from product development and R&D services in India stood at US$3 bn, up from US$2.3 bn last year.

A conducive regulatory environment

The government has revised foreign equity ceilings in aviation services, private banks, non-news publications, petroleum industry, real estate & nuclear power production. Defence was also freed for private sector investment in 2001 with 100% domestic private sector participation. Foreign Direct Investment (FDI) is, however, restricted to 26%.

Important policy initiatives announced recently include:

- FDI limit in domestic airlines sector raised to 100% for Non-Resident Indians (NRIs) and 49% for others and placing it under the automatic route
- Allowing FDI up to 100% subject to certain conditions under the automatic route for development of townships, housing, built-up infrastructure and construction development projects
- Allowing up to 100% FDI in petroleum product marketing, oil exploration in both small and medium size fields & in petroleum product pipelines.

Procedural simplification for approvals of proposals for new joint ventures, technology collaborations with existing joint ventures, technology transfer/trade marks agreement in India and transfer of shares from existing Indian companies. The Government has also placed the following three categories under the automatic approval route:

- Increase in foreign equity in a company
- Conversion of preference shares into equity capital
- Conversion of foreign loans into equity

Another significant development for investors is the government's resolve to revise Press Note 18, which necessitated foreign investors with existing investments to obtain a 'no objection certificate' from their domestic partner before starting any new venture.

The existing FDI regime has become more consistent with the generally liberalized regulatory environment in India.

Conclusion

With the Indian economy expected to demonstrate strong growth on a sustained basis, large foreign private equity firms are showing active interest in the country. Warburg's painless and profitable exit sent an important signal to the private equity community that India is finally open for business. It also reflected depth and maturity in the Indian market. Private equity investors from around the globe are increasing their bets on Indian corporates or making new ones.

We believe that the best deals are yet to happen. Indian PE industry is at a key inflection point and there's no looking back. The 8% GDP growth rate in the short to medium term and the continuance of the reform agenda will play a key role in attracting foreign investors and shall boost future deal activity. ■

Gagan Kapur is an Associate Vice President with Ernst & Young's Private Equity Group

2 India FAQ: The Top Twelve Questions For Foreign Investors

INDIA'S UNIQUE BUSINESS CULTURE AND ENVIRONMENT means foreign investors face more uncertainties than they would in familiar home markets. While every deal is unique, foreign investors considering Indian opportunities typically ask many of the same questions related to Indian business culture, exits, taxes, government, company structuring, and corporate governance. Drawing on the insights of our India -based Transaction Advisory Support and Tax teams, we have assembled a list of India FAQ for foreign investors.

Question 1:

What are the alternative investment routes available for a foreign entity seeking to acquire a stake in an Indian company?

A foreign entity may invest in India under any of the following routes:

- Foreign Direct Investment (FDI)
- Foreign Institutional Investor (FII)
- Foreign Venture Capital Investor (FVCI)

Investment under the FDI route and the FVCI route is discussed later in this note. As regards the FII route, qualified foreign entities seeking to undertake portfolio investments in India are regarded as FIIs. FIIs can invest in Indian equities and debt subject to specified limits.

Question 2:

What is the Foreign Direct Investment (FDI) policy in India?

The FDI policy is relevant to foreign entities seeking to establish an Indian presence by setting up an Indian company (either wholly owned or in joint venture with an Indian partner) or by acquiring stake in an existing Indian company. Over the last 15 years, the Government of India (GOI) has significantly liberalised the FDI policy for foreign investment in India. Currently, the FDI policy permits upto 100% foreign investment in most sectors including the services sector under the automatic route. FDI in sectors under the automatic route does not require any prior approval from either the GOI or the Reserve Bank of India (RBI), however, the Indian company is required to intimate the RBI of certain details relating to the issue of shares.

FDI is allowed under the automatic route in all activities/sectors except the following, which require prior approval of the GOI:

- Activities that require an industrial licence;
- Proposals in which the foreign investor has a previous or existing venture/tie up in India[1] in the same field;
- All proposals relating to acquisition of shares in an existing Indian company by a foreign investor in the financial services sector; All proposals falling outside notified sectoral policy or under sectors in which FDI is currently not permitted.

Where FDI is not allowed under the automatic route, prior approval of the GOI would be required.

The Foreign Investment Promotion Board (FIPB), an administrative body functioning under the Ministry of Finance, considers all proposals for foreign investment that requires GOI approval. As per the FDI policy, an application made to the FIPB is disposed off within 30 days of submitting an application.

Question 3:

Are there any special investment vehicles required or useful in India?

The requirement for a special investment vehicle depends on an investor's objectives in India. If the investor is intending to make long-term investments (time horizon exceeding 12 months) in an Indian listed company, there is no requirement to structure the investment through a special investment vehicle. This happens because long-term capital gains are not subject to tax in India, provided the sale is entered into on a recognised stock exchange in India and payment of securities transaction tax (currently 0.1% on the transaction value). On the other hand, investors seeking an exit within 12 months, or investors seeking to make investments in unlisted Indian companies that are not likely to list on an Indian stock exchange, should consider establishing an offshore investment holding vehicle before making the investment.

A private equity/venture capital fund looking at making investments in India significantly in unlisted companies could consider obtaining registration from the Securities and Exchange Board of India (SEBI) as a Foreign Venture Capital Investor (FVCI). The SEBI and the RBI have extended certain benefits to funds registered as a FVCI, which may make the registration more attractive from a commercial perspective.

[1]The reference date for previous or existing venture/tie up is January 12, 2005 (Press Note no 3 of 2005)

Some of the key benefits of registration as a FVCI are:

- The Indian tax laws provide a pass through status to SEBI registered venture capital funds. Accordingly, on registration, investors in a FVCI are taxed in the same manner as if the investment were made by the investors directly in the investee company.
- Typically, the price at which shares of an unlisted Indian company are divested by a non-resident are subject to RBI pricing guidelines issued in this regard. This may be a deterrent for an exit through a strategic sale or buy-back. However, for a registered FVCI, these pricing guidelines are not applicable and such transactions can be executed at a negotiated price agreeable to the buyer and seller.
- Registered FVCIs are accorded the status of a Qualified Institutional Buyer (QIB) under the SEBI guidelines for disclosure and investor protection. QIBs have an allocation of 60% of the issue size of a public offer of a company.

Question 4:

Are there any restrictions on repatriation of capital invested and profits earned in India?

Capital and income arising from foreign investment in India can be freely repatriated (except for cases where the investment is made on non-repatriation basis), subject to provision of a no-objection certificate from the Indian revenue authorities or a certificate from a chartered accountant confirming that taxes payable, if any, are deposited into the Indian government treasury.

Question 5:

Are there any regulatory approvals required for transfer of shares in an Indian company?

The GOI and the RBI have recently liberalized the procedures relating to the transfer of shares between residents and non-residents Currently, there is no requirement to seek approvals of the FIPB/RBI, subject to compliance with the following conditions:

- The transfer is in accordance with the pricing guidelines prescribed by the SEBI/RBI;
- The shares transferred are not of an Indian company engaged in the financial services sector;
- The transfer does not attract the provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997;
- Activities of the Indian company are under the automatic route under the FDI policy;
- Non-resident shareholding after the transfer does not exceed the prescribed sectoral limits under the FDI policy.

Transfer of shares between non-residents does not require approvals of the FIPB/RBI and pricing norms do not apply to such transfer of shares, subject to fulfilment of specified conditions.

Question 6:

What are the jurisdictions that have been typically used for structuring investments into India?

In recent years, structuring investments through tax friendly jurisdictions has evolved as an effective tax planning tool. In this regard, Mauritius has been a preferred destination for many foreign investors investing in India, given the exemption from tax on capital gains provided by the India-Mauritius tax treaty coupled with the favourable tax regime for taxation of offshore funds in Mauritius. A recently concluded Comprehensive Economic Cooperation Agreement between India and Singapore has provided an additional jurisdiction for structuring investments into India, subject to fulfilment of specified conditions, which would need to be examined based on the facts of each case. Other jurisdictions with which India has a favourable tax treaty (for taxation of capital gains) include Cyprus and United Arab Emirates though these jurisdictions are relatively untested.

Typically, the following parameters are considered by foreign investors while structuring investments through a special purpose vehicle set up in a tax friendly jurisdiction:

- Tax friendly country having tax treaties with both host and home countries;
- Lower or no withholding tax on payment of dividends, interest, royalties, etc;
- Low/nil incidence of tax in the tax friendly country;
- Availability of foreign tax credit;
- Capital gains exemption;
- Low set-up/compliance costs; and/or
- No or less stringent anti-avoidance rules ie treaty shopping, controlled foreign corporation guidelines, transfer pricing guidelines, thin capitalisation norms, etc.

Question 7:

What domestic tax laws needs to be factored into the early days of a company?

Under the constitution of India, the power to levy taxes is divided between the central government and the state governments.

The central government levies direct taxes such as income-tax (personal and corporate) and indirect taxes such as customs duty, excise duty, stamp duty, central sales tax and service tax.

The state governments generally levy professional tax, stamp duty, entry tax and state sales tax. Local authorities governing designated areas within a state also levy taxes such as property tax, road tax, octroi, etc. Recently, the GOI has embarked on an initiative to integrate all indirect taxes (central and state) into a comprehensive goods and services tax regime.

From a foreign investor's perspective, especially where the investment is in an existing Indian company, it becomes very critical to understand the company's level of compliance with various taxes affecting its business.

Question 8:

What are the key considerations that should go into finalising the investment/operating structure for any private equity/venture capital fund intending to invest in Indian companies?

The ability to distribute superlative returns with minimum tax leakage to the "ultimate" investors is a paramount consideration while identifying an investment structure for any private equity/venture capital fund. Typically, most of the investments are structured through jurisdictions that afford a favourable domestic and cross border taxation regime with the country where investments are proposed to be made (see question 6).

The operations (in India and overseas) of the private equity/venture capital fund with respect to its Indian investments have to be carefully structured to ensure that its operations do not constitute a permanent establishment (PE) (ie a place of business) in India.

The implications of constituting a PE is that income/gains may be taxable in India, to the extent that income is determined to be attributable to the activities carried on in India. The PE exposure can be minimised by implementing certain precautionary measures that should be adopted at the outset and throughout the fund's involvement in India.

The tax consequence arising from employee participations in incentive plans should also be analysed in the context of the overall structure. Innovative structures could be evolved to achieve the twin objective of mitigating the risk of constitution of a PE in India while at the same time making such participations tax efficient for the employee.

Additionally, all transactions between associated enterprises should be at arm's length in compliance with the Indian transfer pricing legislation.

In summary, investments by a private equity/venture capital fund are of a longer duration with gains being realised upon divestment/dilution of stake. To mitigate adverse Indian tax consequences, it is preferable that the above considerations are addressed at the time of set-up itself and observed during the entire life cycle of the investments in India.

Question 9:

What are the statutory obligations in case of a substantial acquisition of shares by a company?

SEBI regulates the substantial acquisition of shares in an Indian listed company. An acquirer company has to adhere to certain disclosure requirements in case the acquisition of shares in a company exceeds specified limits. Further, in the following instances, the acquirer company is required to make an open offer to the public:

a) *15% shares or voting rights:* An acquirer who intends to acquire shares which alongwith existing shareholding would entitle the acquirer to exercise 15% or more voting rights, can acquire such additional shares only after making a public announcement to acquire atleast additional 20% of the voting capital of the target company from its shareholders through an open offer.

b) *Creeping acquisition limit:* An acquirer who holds 15% or more but less than 55% of shares or voting rights of a target company, can acquire more than 5% additional shares in any financial year (ending March 31) only after making a public announcement to acquire atleast additional 20% shares of the target company from the shareholders through an open offer.

c) *Consolidation of holding:* An acquirer who holds 55% or more but less than 75% shares or voting rights of a target company, can acquire further shares or voting rights only after making a public announcement to acquire atleast additional 20% shares of the target company from the shareholders through an open offer.

Question 10:

What are the pricing norms in the case of allotment of shares on a preferential basis by a company?

Issue of shares by an Indian listed company on a preferential basis should be at a price not less than the higher of the following:

The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date; or

The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the two weeks preceding the relevant date.

Relevant date is defined to mean the date 30 days prior to the date on which the general meeting of the shareholders is held to consider the proposed issue. Issue of shares by an Indian unlisted company should be at a price not less than the fair valuation of shares done by a chartered accountant as per the guidelines issued by the erstwhile Controller of Capital Issues.

Question 11:

What are tax rates on income from investments made in India?

Investors investing in Indian securities, typically earn the following types of income/gains:

- Gains from transfer of Indian securities
- Dividend income
- Interest income

As per the Indian tax laws, non-residents (organized as a corporate entity) are taxed on their income arising from Indian investments at the following base rates (to be increased by appropriate surcharge and education cess):

For SEBI registered Foreign Institutional Investors, interest on securities is taxable at the rate of 20%, Long-term capital gains and short-term capital gains on sale of shares, etc, other than on a recognised stock exchange are taxable at the rate of 10% and 30%respectively.

As mentioned earlier, the Indian tax laws provide a pass through status to registered FVCIs; the investors in a FVCI are taxed in the same manner as if the investment were made by the investors directly in the investee company. The rate at which the investors are taxed would accordingly depend upon the status of the investors.

The rates mentioned in table 4 are subject to relief under the applicable tax treaty provisions. To the extent that tax treaty provisions are beneficial, they override the provisions of the domestic tax laws.

Further, depending upon the applicable tax treaty provisions and the domestic tax rules, credit for taxes paid in India (including underlying tax credit for tax paid by investee company) may be available against the taxes payable by the investor in its country of residence.

Table 4 : Tax Rates

Nature of income	Rate of tax (%)
Dividends	Nil[2]
Interest (debt incurred in Indian Rupees)	40
Interest (debt incurred in foreign currency)	20
Short-term capital gains (on sale on recognised stock exchange)	10
Short-term capital gains (others)	40
Long-term capital gains (on sale on recognised stock exchange)	Nil
Long-term capital gains (others)	20
Other income	40

Question 12:

What is the scenario for protection of intellectual property rights (IPRs) in India?

India is a signatory to the agreement concluding the Uruguay Round of GATT negotiations establishing the World Trade Organisation. The agreement, inter-alia, contains an agreement on Trade Related Intellectual Property Rights (TRIPS) that lays down minimum standards for protection and enforcement of IPRs in member countries. The TRIPS agreement came into force from 1 January, 1995.

The statutes in India for protection of TRIPS include:

- The Trade Marks Act, 1999
- The Copyright Act, 1957
- The Patents Act, 1970
- The Designs Act, 2000
- The Geographical Indications of Goods (Registration and protection) Act, 1999
- The Semiconductor Integrated Circuits Layout-Design Act, 2000
- The Protection of Plants & Varieties and Farmers Rights Act, 2001; and
- The Biological Diversity Act, 2002
- India has complied with its obligations under the TRIPS agreement, making the Indian IPR law regime almost at par with regimes of developed countries. ■

[2] A dividend distribution tax of 12.5% is to be paid by the co mpany distributing dividends

3 What Investors Need to Know About the Differences Between Indian GAAP and US GAAP

U.S VENTURE CAPITAL AND PRIVATE EQUITY INVESTORS are increasingly looking to India for investment opportunities with a view to exiting those investments through an IPO on a U.S. exchange or a trade sale. One of the challenges of investing in India for U.S investors is being able to understand and compare investment opportunities from a familiar frame of reference: US GAAP. Moreover, an IPO on a U.S. exchange or a sale to a US investor, requires the conversion of a company's financial statements from Indian GAAP to US GAAP. Knowing the likely impact of this conversion is therefore important in assessing both investment and exit opportunities.

Many changes have been made to Indian GAAP in the last five years as a result of India's rapid economic growth and the significant reforms made to its economic system. While business processes in India have historically not been as sophisticated as those in more developed economies, this situation is changing rapidly. Although Indian GAAP is increasingly getting convergent with US GAAP (and IFRS), differences remain in practice.

In general, US GAAP is more rules based in a number of areas than Indian GAAP, particularly in areas such as revenue recognition and consolidation. Thus, there are more alternative accounting treatments under Indian GAAP, allowing a company greater latitude in the interpretation and application of accounting principles. The conversion of financial statements from Indian GAAP to US GAAP can often result in:

- Significantly lower reported revenues, and other revenue recognition issues.
- Unexpected charges or income related to business combinations.
- Reduced net income due to stock option accounting.

Understanding the impact of Indian GAAP to US GAAP conversion will help U.S. investors to calibrate their expectations correctly and – with the assistance of professional financial advice – better evaluate investment opportunities in India. The impact is even more important if a public offering is required on a U.S. exchange or an acquisition by a non-Indian company has US GAAP statements as a closing condition. While each company's situation is unique, we briefly outline some of the key differences between the two comprehensive bases of accounting for U.S. investors to be aware of as they consider investments and exits in India.

Assessing Indian-to-US GAAP Conversion: Where to start

The first question to ask is whether the company's financial statements are audited by a reputable international accounting firm. In India, if a company is not audited by a reputed international accounting firm with expertise in US GAAP, the quality of its US GAAP financial statements should be carefully examined because local accounting firms may not have exposure to international reporting requirements.

Bottom line for US investors

Preparation or examination of a reconciliation from Indian GAAP to US GAAP by a reputable firm is a good starting point in assessing the company's financial situation.

Indian-to-US GAAP Conversion: Significant Adjustment Areas

In converting from Indian GAAP to US GAAP, there are a number of areas that can have an impact on the bottom line and consequently affect the decision on a company's attractiveness as an investment. Some major areas for potential differences are revenue recognition; accounting for business combinations; stock options and other employee benefits. The differences discussed below are only illustrative and not intended to be exhaustive. There are several additional differences related to topics such as prior period items, defined benefit plans, variable interest entities, derivatives, impairment and foreign exchange gains and losses.

Revenue Recognition

While revenue recognition rules (as described) for manufacturing companies are very similar in Indian GAAP and US GAAP, there may be differences in practice with respect to determination of when delivery occurred, price is fixed, what are the contractual elements, whether collection is probable and whether significant obligations remain. Additionally, rules related to revenue recognition for software, long-term contracts and services are often very different. US GAAP has specific guidance for revenue recognition in certain industries, such as software, whereas there is not similar specific and prescriptive guidance in Indian GAAP. Some of the key differences in revenue recognition between Indian GAAP and US GAAP include:

Recognition Timing: US GAAP has certain rules regarding when revenue resulting from sales transactions involving rights of return, warranties, extended payment terms, installation clauses or post-contract support services can be recognized. If requirements cannot be met in these cases, generally the revenue is deferred. In Indian GAAP, because there is no specific guidance, Indian companies may have recognized the revenue as soon as the first service component has been delivered. Converting from Indian GAAP to US GAAP could result in previously recognized revenues being deferred, because specific criteria and guidelines in US GAAP were not met.

Multiple-Element Contracts: US GAAP also has specific rules for recognizing revenue related to contracts which involve multiple elements, such as a systems integration project by a software company that combines hardware, software and integration services. Under US GAAP, revenue arrangements in such cases should be divided into separate units of accounting if certain criteria are met. Arrangement consideration is allocated to the separate units of accounting based on their relative fair values and applicable revenue recognition guidance is followed for each unit of accounting. If elements in an arrangement cannot be divided into separate units of accounting, revenue may, in certain circumstances, be deferred and recognized when remaining undelivered items are delivered. Under Indian GAAP, there is no standard that deals with multiple element contracts, though there is an opinion from a committee of the standard setter, which requires the components to be fair valued and recognized as they are performed.

Nevertheless in the absence of a clear cut standard, the practice for accounting multiple element contracts may vary amongst companies and may not be in accordance with US GAAP principles. As a result, in converting from Indian GAAP to US GAAP, recognized revenue might have to be deferred.

Gross vs. Net Recognition: Under US GAAP, a company that acts as an agent can often only recognize net revenue which might be a commission or a fee. An Indian company, may have been determined revenue based on invoiced amounts that include certain amounts paid to suppliers. While the net income may not be affected by such differences, it may result in differences in the top line. As a result, reported revenues may be higher than it would be under US GAAP

Barter Transactions: Under US GAAP, the fair value of goods or services exchanged in barter (non-cash) transactions is recorded as revenue only in limited circumstances. For example, if a company receives a product in exchange for free advertising, certain criteria must be met prior to advertising revenue being recognized, including a determination of whether the fair value of the product or advertising can be made and whether there were similar cash transactions. Under Indian GAAP, companies may have recognized revenue if the value of the goods or services exchanged was considered determinable. Consequently, where companies have engaged in significant non-cash based transactions, revenues under US GAAP could be lower.

Bottom line for US investor

Be aware that revenues and/or net income will likely be significantly adjusted in the conversion from Indian to US GAAP, particularly in the case of software and service companies or companies that have engaged in substantial exchanges of goods and services.

Business Combinations

Accounting for business combinations, mergers and acquisitions represents another area where significant adjustments would likely have to be made in an Indian to US GAAP conversion, most likely resulting in a change in net income.

Under US GAAP, when a company acquires another company that constitutes a business, only the purchase method can be used. Accordingly, the acquiring company must compare the consideration (the amount paid) to the fair value of the net assets acquired. Along with the tangible assets, the intangibles assets such as customer lists or brand names, should be identified and valued. The difference between the consideration paid and the fair value of the net assets acquired is recorded as goodwill. Goodwill is not amortized but reviewed for impairment annually.

In Indian GAAP, when the acquired entity loses identity either the pooling of interests method (when certain conditions are fulfilled) or purchase method can be used. In the purchase method, both fair value and carrying value can be used to value the net assets acquired. Goodwill is amortized over a period not exceeding 5 years. When the acquired entity does not lose its identity, the purchase method based on the carrying value of the net assets is applied to determine goodwill. Such goodwill may or may not be amortized but has to be tested for impairment.

Bottom line for US Investors

If you are considering investing in an Indian company that has made an acquisition, or your Indian portfolio company is planning to make an acquisition, be aware that a Indian-to-US GAAP conversion could result in significant changes to recorded assets, including goodwill, and consequently in net income as a result of differences in depreciation and amortization, among others. Note, however, that converting to US GAAP may cause net income to be higher as goodwill is not amortized under US GAAP.

Stock Options

Stock Options have been widely used in the U.S. for a long time. In India, it is relatively a recent phenomenon.

Under US GAAP, there is new accounting guidance for employee stock option grants which is applicable for fiscal years of public companies beginning after June 15, 2005 and beginning after December 15, 2006 for nonpublic companies. Under that guidance, when a company grants stock options, it must estimate the fair value of the options at the grant date using an option pricing model. As those options vest, the company recognizes that measured fair value as stock option compensation expense.

Additionally, options granted to non-employees are required to be re measured at fair value over the performance period, with a final measurement at the conclusion of the performance period. Over the performance period, the aggregate amount of compensation expense recognized is equal to the re-measured fair value at each reporting date multiplied by the portion of the performance period that has transpired as a percentage of the total performance period.

In Indian GAAP, the treatment of stock options is closer to the old rules under US GAAP. Stock compensation cost is generally recorded under the intrinsic value method (fair market value of the stock less the exercise price), although companies may choose to use the fair value model. Additionally, there are no standards under Indian GAAP with respect to options granted to non-employees. Under Indian GAAP, although there is no standard related to stock options granted to customers, there is an opinion from a committee of the standard setter which requires the options to be fair valued and recognized as a charge over the period revenues are received.

Bottom line for US investors

Take a close look at the stock compensation plan of potential or current investee companies in India to understand what will happen to net income when stock options are accounted for according to US GAAP. Also pay close attention to whether options have been granted to non-employees or customers.

Indian-to-US GAAP Conversion Success Factors

There are several straight forward steps that can be taken to make the conversion process go more smoothly:

- ***Start Early:*** Generally speaking, Indian companies should make the conversion to US GAAP at least two years before they list on a U.S exchange. Additionally, Indian companies may need to become compliant with Sarbanes-Oxley. Putting the necessary business processes and internal controls in place is a time consuming exercise that could delay the IPO process if it is not started on a timely basis.

- ***Hire the Right Accounting Manager:*** Hiring an accounting manager, whether controller or finance director, who has in-depth knowledge of US GAAP, is important for a successful transition. Since it is not easy to find someone with US GAAP knowledge in India, time to recruit or train the right individual must be factored in.

- ***Involve an International Accounting Firm:*** Involving an international accounting firm that can help management understand the key differences between Indian GAAP and USGAAP. ■

4 Due Diligence Success Factors in India

Foreign direct investment is flowing into India at a record pace as multinational corporations and private equity investors cash on the opportunities that India offers — high growth economy, stability polity, English speaking and well educated workforce, management and technological talent and much more.

With increasing prospects for transactions in India, it is critical to understand what makes for a successful due diligence in this land of opportunities M&A activity has soared in India since economic liberalisation was introduced in the mid 1990s. Strong private equity and venture capital interest has further spurred action. For U.S. and European investors seeking to participate in Indian M&A opportunities, due diligence is a critical step, not only to reduce risks, but also to understand the target company's business culture. Those familiar with India will agree that the country's business culture is very different from what western investors are accustomed to. Understanding what this difference means for due diligence where two business cultures essentially meet face to face will help foreign investors approach this process with the appropriate expectations and achieve greater transaction success.

Table 5 : Doing Due Diligence Western Countries Vs India

	Western Countries	India	
		Large Companies with prior M&A experience	**Others**
1. Transparency in financial information	High	Medium	Low to Medium
2. Normal duration of due diligence	1-8 weeks	1-8 weeks	3-12 weeks
3. Assistance required by target company to prepare for due diligence	Minimal	Minimal	Generally require assistance
4. Basis of financial information	US GAAP and IFRS	Generally Indian GAAP,some companies prepare as per US GAAP or IFRS	Indian GAAP
5. Audited financial information	By reputable standards	By reputable standards	May not be very reliable
6. Extent of related party transaction	Varies; typically fully disclosed	Usually extensive; fully disclosed	Usually extensive; may not be fully disclosed
7. Disclosure of contingent liabilities	Usually transparent	Generally adequate disclosures	Inadequate disclosures
8. Reliance on computerized systems	Typical	Typical	Evolving; dependence on manual process
9. Reliability on representations and warranties	Normally reliable	Untested	Untested
10. Enforceability of indemnification	Strongly; backed by courts	Untested: may need to consider "holdbacks"or "escrows"	Untested: may need to consider "holdbacks"or "escrows"

Opening the Doors

For nearly four decades since it achieved independence from British colonialism in 1947, India operated under a traditional closed economy with stringent government regulations and high tax rates. Traditionally, a majority of the Indian companies have been family-owned and managed, without strong management information systems (MIS) and control procedures. Although, in the last few years, there have been significant additions and revisions in Indian GAAP and increase in compliance requirements under Corporate Governance guidelines, but full compliance with these norms is some distance away.

Ten tips to Successful Due Diligence

Here are a few basic suggestions to maximize your chances of deal success:

1.Know the mindset of the target company

Small and medium sized Indian Companies typically lack prior M&A experience and hence, they take more time to prepare for the due diligence as compared to their counterparts in the developed countries. Further, the comprehensive information required for the due diligence process is not readily available with the Indian Companies due to lack of detailed management information system. For example, detailed schedule of margins by product and by customer may not be easy to come by with these companies.

The forecasting methodologies of such small and medium size Indian companies are not very robust, often leading to simplistic projections. The forecasts tend to be aggressive, without a track record to boot.

This does not help the potential investor to derive confidence and rely on the company estimates. .

2. Understand key differences in doing a due diligence in the western countries and in India

Going in for a due diligence process with the right expectations is a critical success factor for US and European investors. The quality of financial statements, financial infrastructure and business and business process will be lower and less explicit than western investors are accustomed to. This results in the need to explore more risk areas and take more time for the due diligence. Some of the differences between due diligence in western countries and India are set out in table 5.

3. Listen for the word "NO":

Asian culture is less direct in some respects than western culture, which often leads to misunderstanding in the business milieu. Western investors rarely hear their Indian counterparts say "no" even though they do not mean "yes". Do not be drawn into a false (and protracted) process of assuming cooperation by the other side without defined actions and deadlines. When discussing potentially contentious items, reduce discussions to writing and agree dates, if appropriate.

4. Look out for Hidden Skeletons:

Inadequate disclosures impede the ability to access critical information that might alter the investor's perception with regard to the value of the company, environment issues and aggressive tax positions among others. Historically, due to high tax rates, Indian companies have adopted aggressive tax positions including cross holdings and complex structures.

5. Evaluate Corporate Governance:

Its early days for stronger corporate governance guidelines and enforcement in India. However, the regulators are tightening norms and pushing for greater accountability. Companies are slowly realizing the importance of corporate governance and some of the leading organisations are benchmarking to global standards. Some others are moving towards improvement.

6. Keep an Eye on Related Party Transactions:

As a hangover of the licensing raj, Indian businesses are generally structured as conglomerates or group businesses which creates extensive related party transactions. Group companies may be structured in such a way that they would not be captured in the mandatory disclosures by the accounting standards and the Company Law. A good understanding of informal practices and assumptions helps understand the correct implications of transactions with related parties.

7. Avoid Legal Minefields

Weak corporate governance is compounded with tardy legal systems where dispute resolution often remains a distant goal. There are significant issues of enforceability of key contractual rights and statutory protection.

8. Communicate with Care

In any transaction, communication must be handled with utmost care. Sensitivity to Indian culture with regard to dealing with the owners who are also the entrepreneurs of the company will help to make the venture more rewarding.

9. Manage the Control freaks

It is often observed that founding members of a start-up will refuse to give up control and settle for a minority ownership stake (a common condition for many start-ups in exchange for Private Equity funding). Even in larger companies, founders generally prefer the financing options which do not require them to give up 'control' or 'information rights'. However,

some Indian companies, whose corporate governance practices are not perceived very well in the market, in order to improve their perception of corporate governance prefer an institutional investor with board seats and informational rights. This helps them gain confidence of other investors. Also, situations where manager entrepreneurs accept professional CEOs to run their business and they in turn report to such professional CEOs is not very common in India. It may take some time before this becomes a more acceptable practice.

10. Think Global, Act Local

With several success stories of various private equity firms in India, the country has become a favorite of most of the funds. Thus, there has been an increased competition among the investors to close deals in record low time. Firms with a presence in India have a distinct edge due to their wide networks of contacts and experience of the Indian business environment.

Table 6 : Due Diligence : Initial Information Review*

Tasks	Objective
1. Screening historical financial statements	Understand key business drivers, quality of earnings and related issues, working capital requirements, etc.
2. Evaluate key accounting policies	Identify potential risky sensitive areas that need additional attention in due diligence, valuation and structuring
3. Perform high level overall analytical review	Assess integrity and quality of financial data
4. Assess financial/accounting environment	Understand the limitations of the current accounting software, set expectations of the extent of financial data available for further analyses
5. Review internal management reports	Identify useful business statistics that are instrumental to in-depth analysis
6. Understand business and their financial impact	Determine impact on valuation and identify areas for further detailed due diligence
7. Develop a comprehensive Information Request List for detailed due diligence	Ensure that sufficient information and data are available to facilitate appropriate analyses

*Normally in Pre-LoI Data Gathering stage

Table 7 : Due Diligence : Drill Down in Depth**

Possible Tasks	Objectives
Phase I	
1. Review audit workpapers	Identify risk areas which need special attention
2. Raise asset/liability questions	Validate book value of assets/liabilities and assess the impact on future earnings
3. Analyse income statement fluctuation	Understand the seasonality of the business, assess quality of earnings etc
4. Identify potential pro forma adjustments	Ensure that historical profitability of the acquired business is truly reflected
5. Assess stand alone matters	Evaluate standalone costs incase of carve-outs.
6. Identify contingent liabilities	Determine impact on valuation and identify areas for detailed due diligence
Phase II	
1. Evaluate profitability by product/ segment/ geography	Develop in-depth understanding of the business, assess the quality of earnings
2. Analyse correlation between price and volume	Same as above
3. Identify key cost drivers and expense variability	Same as above
4. Review capital expenditure history	Determine impact on valuation
5. Analyse working capital sensitivity and seasonality	Determine impact on valuation and buyers financing needs
6. Analyse projections versus history	Assess the practicability of the projections for profitability, working capital and capex. Determine impact on valuation.
7. Evaluate the human resources and benefits issues	Determine impact on valuation
8. Quantify pro-forma EBITDA	Same as above
9. Discuss findings with target and Finalize Due Diligence report	Present the factual analysis to the target to ensure that facts are correct, and no facts are missed out.
	Summarize key findings and observations, raise alerts, if any, to facilitate investment decision
10. Develop CPs, CSs, Reps, warranties and indemnities for purchase agreement from a financial perspective	Minimizing the investment risk

**Typical Post-LOI Due Diligence Procedures

Note : This phased approach is recommended only where there is concern on quality of financial information provided by target.

Conclusion:

Investment in any foreign country can create anxieties for an investor. In India these anxieties are further exacerbated by cultural differences and unfamiliarity with local business rules. India's economic policies are designed to attract significant capital inflows into India on a sustained basics and to encourage technology partnership agreements between Indian and foreign firms. Policy initiatives taken over the last few years have resulted in significant inflows of foreign investment in all areas of the economy, except those reserved for the public sector

.

Today, India is one of the most exciting emerging markets in the world. Skilled managerial and technical manpower who match the best in the world coupled with a middle class whose size exceeds the population of the USA or the European Union, provide India with a distinct cutting edge.

Understanding some of the main cultural differences, potential pitfalls and due diligence success factors will help you approach investing in India with greater confidence and also to determine when greater investigation and the assistance of a professional advisor is needed. ■

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