CROSS BORDER MERGER & ACQUISITION

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Merger & Acquisitions ('M&A') are increasingly been recognized as a business tool. The most widely practiced business strategy i.e. organic growth story - involving steps that a company would take to augment its human resource, clients, infrastructure resources etc thus resulting in organic growth of its revenues and profits. The M&A route interchangeably used as inorganic growth story would provide immediate extension of company's human resource, clientele, infrastructure thus catalyzing the growth.

Given the fact that the economies are globalizing, more and more M&A are happening. M&A are now driven more with business consideration rather than dominated by regulations. Yet the local legislations do play in role in shaping the M&A.

1. FOREIGN DIRECT INVESTMENT ('FDI') IN INDIA

Exchange control regulations which are critical to the India specific cross border M&A are defined under the Foreign Direct Investment ('FDI') guidelines. FDI in India are governed by the FDI Policy announced by the Government of India and the provisions of the Foreign Exchange Management Act ('FEMA'), 1999. Besides, the Ministry of Commerce and Industry issues series of press notes outlining certain criteria's for the FDI guidelines.

Under the present FDI policy, foreign investments are allowed in an Indian company under the automatic route in almost all sectors except:

(i) *Retail Trading (except single brand product retailing)*
(ii) *Atomic Energy*
(iii) *Gambling and Betting, Lottery Business*
(iv) *Certain Financial Entities*
(v) *Trading in Transferable Development Rights*
(vi) *Activity/sector not opened to private sector investment*

For other sectors, there are two routes for foreign investment in India:

(i) Automatic Route - the foreign investor does not require any approval from the Reserve Bank of India ('RBI') or Government of India for the foreign investment.

(ii) Prior government approval route for foreign investment, in the following circumstances, needs approval:

a) *Activities which require prior government license*
b) *Proposal exceeding the sectoral caps or where provisions of Press Note 1 (2005 Series) issued by the Government of India are attracted;*
c) *Where more than 24 per cent foreign equity is proposed to be inducted for manufacture of items reserved for the Small Scale sector*
d) *Proposal for acquisition of shares of an Indian company in Financial Sector and where the transactions attract the provisions of SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997.*

1.1 Press Notes

The Press Notes are announced by the Ministry Of Commerce and Industry. The Ministry issued Press Notes 2, 2009 and Press Note 3, 2009, which deals with calculations of foreign investment in downstream entities and requirement for Foreign Investment Promotion Board ('FIPB') approval in relation to transfer of ownership or control in sectoral cap companies. These press notes raised certain key issues, including with respect to the downstream investment.

1.1.1 Calculation of Foreign Investment

Investment by Non-resident in Indian Companies is referred as Foreign Direct Investment ('FDI'). Investment by Foreign Institutional Investors ('FIIs'), Non Resident Indians ('NRIs'), American Depository Receipts (' ADRs'), Global Depository Receipts ('GDRs'), Foreign Currency Convertible Bonds ('FCCBs'), Compulsory Convertible Preference Shares and Debentures are treated as FDI. Besides Indian entities promoted by non-residents can also invest in Indian Entities. This may result in Foreign Indirect Investment. Unlike the FDI, calculation of foreign indirect investment requires analysis of the Investing Indian Company ('IIC').

Foreign investments are not treated as FDI where the IIC is *"Owned & Controlled"* by resident Indians citizens and/or Indian companies *"Owned & Controlled"* by resident Indian citizens. Otherwise, when the IIC is *"Owned or Controlled"* by non-resident entities, the entire investment by the IIC into Indian Domestic Company ('IDC') would be considered as indirect foreign investment.

This can be clarified through following examples –

(a) Case where there would not be any Indirect Foreign Investment

Investments made by IIC (wherein the foreign investment is less than 50 per cent) in IDC would not be lead to any indirect foreign investment.

(b) Case where there would be Indirect Foreign Investment

IIC (wherein the foreign investment is more than 50 per cent say 75 per cent) ***invests***

(i) 26 per cent in IDC - the entire 26 per cent invested by the IIC would be treated as indirect foreign investment in IDC.

(ii) 80 per cent in IDC - the entire 80 per cent investment by IIC would be treated as indirect foreign investment.

(iii) 100 per cent in IDC - only 75 per cent invested by IIC would be treated as indirect foreign investment.

For the purpose of enforcement of sectoral caps, the sum total of direct and indirect foreign investment would be relevant besides sectoral conditions.

1.1.2 Downstream Investment

Companies owned and controlled by non-resident entities are required to follow foreign investment norms on entry route, conditions and sectoral caps. The applicable guidelines classify such companies as

(a) Operating Companies

Foreign investment in *Operating Company* (defined as an Indian Company which is undertaking operations in various economic activities and sectors) would be in accordance with the relevant sectoral conditions on entry route.

(b) Operating Cum Investing Companies

Foreign investment in Operating *cum* Investing Companies would have to comply with the relevant sector specific conditions. Further the downstream investment in IDC would have to comply with the relevant sectoral conditions on entry route.

(c) Investing Companies

Foreign investment in *Investing Companies* will require prior Government/Foreign Investment Promotion Board ('FIPB') approval. Further the downstream investment in IDC would have to comply with the relevant sectoral conditions on entry route.

2. FOREIGN DIRECT INVESTMENT THROUGH TAX FAVOURABLE JURISDICTIONS

India has entered into comprehensive Double Taxation Avoidance Agreements ('DTAA') with 79 countries, limited DTAA with 15 countries and other 3 agreement in the form of double taxation relief rules. DTAA assume significance where a tax payer entity has transactions in more than one country and is liable to tax in more than one jurisdiction. The DTAA provide a statutory guidance in solving the disputes arising out of the trans-national transactions of financial significance. DTAA provides for relief from the double taxation in respect of incomes by providing exemption and also by providing credits for taxes paid in one of the countries. These treaties are based on the general principles laid down in the model draft of the Organisation for Economic Cooperation and Development (OECD) with suitable modifications as agreed to by the other contracting countries. DTAA are based on an underlying assumption that a taxpayer is liable to tax in atleast one tax jurisdiction. Taxpayers across the globe indulge in a number of methods to reduce the tax by careful and legal tax planning and at times by indulging in tax avoidance. In international tax domain, the tax avoidance devices mis-utilise the DTAA in the form of Transfer pricing, Treaty Shopping or Misuse of DTAA's in tax havens. MNC's used TH countries to minimize their total group tax by effectively shifting profits from high tax jurisdictions to the tax haven countries. This practice has considerably reduced due to the new transfer pricing regime in most tax jurisdictions globally.

- **Mauritius**

Mauritius is the single biggest source of foreign direct investment (FDI) in India - amounting to USD 46,335 during April 2000 till January 2010 (about 43 per cent of the total FDI received by India during such period). But that is not all. Mauritius-based foreign institutional investors ('FII') are major players in the Indian stock market. Yet treaty with Mauritius remains controversial. The key to the apparent controversy lies in the provisions of a two-decade-old bilateral agreement signed between Government of the Republic of India and Government of Mauritius for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for the encouragement of mutual trade and investment on August 24, 1982 as the Double Taxation Avoidance Convention ('DTAC').

Essentially, the treaty simply stipulates that a Mauritian firm investing into India will not be taxed in India and vice versa. Among other things, the treaty specified that capital gains made on the sale of shares of Indian companies by investors resident in Mauritius would be taxed only in Mauritius and not in India. A firm registered in Mauritius investing in the Indian markets does not have to pay any sort of capital gains tax which can be as high as 30 per cent on short-term gains made on an unlisted company's shares when it decides to book its profits and repatriate the money.

Thereafter, for nearly 10 years the treaty existed only on paper since FIIs were not allowed to invest in Indian stock markets. India opened it economy in 1991-92 and coinciding with the liberlisation Mauritius passed Offshore Business Activities Act which allowed foreign investors to set up Global Business Company ('GBC-1') in the country provided they fulfilled some minimal conditions and paid a nominal fee to the Mauritian authority. The privileges include permission to operate in complete secrecy at a nominal tax payment irrespective of real operations or assets within Mauritius, above all - the privileges of the DTAC.

As per the DTAC, corporate entity, resident in Mauritius has an option to pay income tax in Mauritius at the applicable tax rates even if the taxable income accrues in India. India can only compel the Indian JV / subsidiary to withhold tax (5-15 percent) on the dividend income paid by the Indian Subsidiary to the foreign corporation. The Mauritius Company can exercise the option to repatriate dividend income received from an Indian Joint venture subsidiary with option to pay tax in Mauritius at Mauritius rates of income tax instead of the very high corporate rate of income tax for foreign corporations in India. Further, the dividends paid by the Mauritian company to resident of India could be taxed in Mauritius and according to the tax law in Mauritius, as long as dividends paid by companies resident in Mauritius are allowed as deductible expenses.

Under the Mauritius Offshore Business Activities (MOBA) Act 1992 a corporation known as the MOBA entity has the privilege to pay income tax on dividend income (from India) repatriated into Mauritius on a voluntary basis. Also, by virtue of Clause 13(4) of the DTAC, Mauritius resident in the can choose to pay tax on dividend income, repatriated out of India, under the Mauritius tax laws at Mauritius tax rates.

For foreign investors willing to invest in India, it made sense to set up a subsidiary in Mauritius and route their investments through that country. Through such intentional tax structuring, they could avoid paying capital-gains tax in India all together - India won't tax because the company is based in Mauritius and Mauritius had anyway exempted investors from capital-gains tax. In addition, Mauritius also has low rates of dividend and income taxes.

- Singapore

The India-Singapore Comprehensive Economic Cooperation Agreement (CECA) signed on June 29, 2005, became effective from August 1, 2005. The CECA is preferred by some to route funds via Singapore, considered an ideal Asian business hub. Unlike Mauritius, in Singapore investors can raise capital and establish full presence activities, feature unavailable while routing investment through Mauritius. The treaty also envisages zero capital gains tax treatment to Singapore-based companies by avoiding the double-taxation system. Indian software companies rendering services in Singapore were the manor beneficiaries the CECA. Besides, there is the benefit of a lower withholding tax rate and easing of Visa restrictions.

3. M&A METHODS IN INDIA

With the FDI policies becoming more liberalized since the past many years, Mergers, Acquisitions and alliance talks are heating up in India and are growing at an alarming rate. The policies included opening for international trade and investment in to India allowing the investors across the globe to enter the Indian market without restricting them to one particular type of business. The list of past and anticipated mergers and acquisitions in India covers every size and variety of business providing platforms for the small companies being acquired by bigger ones.

In the recent years, India has become a desired destination among the emerging economies for foreign investors as the FDI inflow has seen an upward trend with countries like Mauritius, Singapore topping the list due to the tax treaties signed by the Government of India with the respective countries. The key factor in making a successful investment through FDI in India lies in understanding the forms in which business can be set-up and comprehending the regulatory framework and mode of operation.

A foreign company planning to set-up its business operations in India has the following options

(i) As an incorporated entity by incorporating a company under the Companies Act, 1956 through

- *Joint Ventures; or*
- *Wholly Owned Subsidiaries*

(ii) As an office of a foreign entity through any of the following modes

- *Liaison Office / Representative Office*
- *Project Office*
- *Branch Office*

Foreign investors may follow different methodologies to invest in the Indian companies. The interest in an Indian company can be acquired through (i) investing in the shares of an unlisted company (ii) investing in the shares of a listed company (iii) establishing a new company and transferring the defined business of the target to a newco. The valuation guidelines/principles with respect to investing in listed and unlisted companies in India are discussed later in this article.

The primary objective of any investment would be to earn the expected return and to receive any available tax advantages. The tax implications for a foreign investor depends on the nature of investment made and the duration of holding the investment as prescribed by the Indian income tax laws.

Any company incorporated in India will be treated as a domestic company irrespective of the foreign company holding. Corporate tax rates applicable to domestic company are 33.22% (Base rate: 30%, surcharge 7.5%, cess 3%) on the profits earned. Dividend distribution tax (DDT) at 16.61% (including surcharge) is further applicable on the distribution of dividends by the domestic company to its investors.

On the other hand, a foreign company can also operate in India by setting up its project office or branch office and the said offices will be treated as permanent establishments in India. All foreign companies are liable to pay a corporate tax of 42.23% (40%+surcharge) on the profits earned from Indian operations. The dividend distribution tax (DDT) is not applicable for a project office or branch office of a foreign company in India. Under the proposed Direct Tax Code (DTC), which may become effective from the financial year 2011, the rate of tax may get reduced to 25% (inclusive of surcharge). However, an additional tax of 15% (inclusive of surcharge) is payable under the proposed Direct tax Code (DTC) as branch profit tax.

Whilst the corporate taxes are paid by the domestic and foreign company on their incomes in India, there might be tax implications on the foreign investors while selling their stake in the Indian company.

On the sale of shares, a long term capital gain tax (if shares are held for more than one year) at 21.12% (including surcharge) is payable. Long term capital gain tax is not applicable if the investee company is listed and security transaction tax (STT) at 0.125% is paid. Short term capital gain tax (if shares are held for less than one year) at 15.84% (including surcharge) along with STT at 0.125% is payable if company is listed. Normal corporate tax of 42.23% is applicable to the foreign investors on short term capital gains if the company is unlisted.

Further, depending upon the applicable tax treaty provisions and the domestic tax rules (discussed previously), 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. The recent growth of FDI inflows into India has shown a lot promise and in the coming years, the Indian government is considering to liberalize its FDI policy to allure more foreign investments in to the Indian economy.

4. VALUATION OF SHARES

Valuation is a technique to assess the worth of the enterprise. Enterprises operate in a dynamic business environment and are subjected to possibilities such as the merger or takeover which leads to need for quantifying the value of the enterprise and the decision on the right price.

According to the foreword to the research study called "A Study on Share Valuation" published by The Institute of Chartered Accountants Of India ('ICAI'). "The subject of valuation has always been controversial in the accounting profession. No two accountants have ever agreed in the past or will ever agree in the future on the valuation of shares of a company, as inevitably they involve in the use of personal judgment on which professional men will necessarily differ.

In the foreword to the second edition further states that "One of the significantly expanding areas has been valuation of shares for various purposes. With the introduction of free pricing of issues of equity, commensurate with the avowed policy of the Government's economic liberlisation, this subject has gained new importance. The valuation exercise would now have economic overtones rather than legalistic determinants. The value of shares of a particular company will depend on various factors like history of earning, the value of its assets, nature of the business and further prospects of the company. Although it is not possible to set any number of definite criteria for the valuation of share in all circumstances, yet a need for some guiding principles can also not be denied, so that it is not reduced to a totally subjective exercise."

As a conclusion, the valuation of shares should be able to provide answers to the following questions

1) *What is the maximum price that should be paid to the seller shareholders?*

2) *What is the justification of the price paid with reference to the value of assets, earnings, cash flows, balance sheets*

3) *What are the financial and regulatory implications of such transaction?*

4.1 Regulatory guidelines on issue and valuation of shares of existing companies

Allotment of shares on preferential basis shall be as per the requirements of the Companies Act, 1956, which will require special resolution in case of a public limited company

4.1.1 Valuation of Shares of a Listed Company

Shares of listed companies are quoted at stock exchange and are available readily. These shares can be sold or bought at the stock exchanges. Market price of the shares reflects their true and fair value. It is presumed that all relevant information of the company is available to the investors, which is reflected in the market price and reinforces further assumption that market is efficient.

In case of listed companies, valuation shall be as per the Reserve Bank of India /SEBI guidelines as follows:

The issue price shall be:

i) 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

ii) 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.

4.1.2 *Valuation of Unlisted Companies*

In case of issue or transfer of shares of an unlisted company to a non resident investor, valuation was done in accordance with the guidelines issued by the erstwhile Controller of Capital Issues (CCI). However, these guidelines are no longer applicable as per the circular of Reserve Bank of India (RBI) dated May 4, 2010.

As per the RBI's circular, in case of an unlisted company price of shares issued to person resident outside India shall not be less than the fair value of share as determined using the Discounted Cash Flow (DCF) method. This valuation can only be done by a SEBI registered Category-I Merchant Banker or a Chartered Accountant.

4.2 Valuation Methodologies

Valuation is a process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is a perception of the value of a business at a given point of time. A realistic business valuation requires more than merely looking at last year's financial statement. It requires a thorough analysis of several years of the business operation and an opinion about the future outlook of the industry, the economy and how the subject company will compete.

There are several techniques to value a business. Broadly, those techniques may be categorized into three types of approaches –

1) Income based approach

   Approach based on future income generated by an organization and is further classified as:

   a) Discounted Cash Flow (DCF) method

      In this, the net present value ('NPV') of discounted cash flow is calculated. It is typically assumed that that the business being valued will have a growth phase (or a discrete period), followed by a steady phase for which a terminal value is calculated. In the growth phase, the business will be expanding and may have high capital expenditure. Revenues may grow steeply or jump to higher levels, as capacities are built up in the company. In the steady phase, the business growth may be slow and not as volatile as in the growth phase.

The DCF model discounts the future estimated cash flows of the company in the growth phase and steady phase at a risk adjusted rate to arrive at an estimate of the present value of the company. The cash flow model assumes that the enterprise is a going concern and that the value drivers of the company are also the drivers of the cash flow of the company.

b) Earning Capitalization method

Through this method a business is valued based on its historical returns. The earnings are capitalized based on those historical returns to represent the company's value. This method is used when the company has had a steady growth and is likely to continue at the same rate.

2) Cost based approach

Where valuation is based on the value of its assets then the following approach is used. This approach is categorized into:

a) Net Asset Value based on Book Value – in this method the assets are valued at the book value as mentioned in the balance sheet of the Company.

b) Net Asset Value based on Market/Current Value – in this method the assets are valued at their current prices i.e. the market value.

3) Market Approach (Relative Valuation)

The approach is also known as the Comparables approach is a widely used technique to value private firms. It is based on the principle of acquiring an asset at a cost of acquiring an equally desirable substitute. The most commonly used method under this approach is 'Relative Valuation' method, in which the value of the company is based on the pricing of the similar firm.

4.3 Correlation and Reconciliation of Valuation Methods and Values

The process of correlation and reconciliation is the analysis of alternative indications of value to arrive at a final value indication. Relative strengths and weaknesses of each method relative to appraisal objective, conceptual conformance to definition of value sought and adequacy of data has to be assessed to arrive at the final valuation.