Challenges in cross-border M&A for domestic companies

Significant reforms related to overseas investment have facilitated the current wave of domestic outbound acquisitions.

June 2000: The government passed the Foreign Exchange Management Act (FEMA), making outward remittances for overseas acquisitions possible. FEMA allows flexibility to adapt to market conditions with discretionary powers exercised by the government and the Reserve Bank of India (RBI).

March 2003: The government significantly revised the “automatic route” (i.e., without prior government approval) for overseas investment.

2010: Domestic companies were permitted to invest up to 400% of their net worth either through the automatic route or with the approval of the RBI. While the ability to invest up to 400% of a domestic company’s net worth is a benefit for conducting outbound M&A, it is also a restriction on a domestic company’s investment activity abroad. This limitation, along with the inability to pledge Indian assets for guarantees or debt financing without RBI approval (which is rarely given in practice), is an important limitation on size and scope of outbound M&A from India.

The government also liberalized the quantum of remittances that could be sent to India from foreign-acquired companies.

However, there are certain financial and legal constraints on M&A activity by domestic firms that continue to impose substantial restrictions on the methods used by domestic companies in pursuing outbound acquisitions as well as on the future potential of domestic companies.

Access to global capital: Traditionally, access to capital has been significantly easier for domestic firms outside of India by listing on foreign exchanges (increases ability to raise debt). Global banks have also become somewhat comfortable funding domestic multinationals’ cross-border M&A because of the growing success of India’s outbound acquisitions.

However, domestic companies continue to face difficulty in raising acquisition financing in India due to regulatory restrictions imposed on domestic banks by the RBI for such funding. These restrictions make it difficult for an acquirer to finance a Leveraged Buy Out (LBO) using a domestic bank.

Thus, most India-based multinationals that have used the LBO structure to raise bank financing use the laws of the jurisdiction of the target company. The typical structure is for the Indian acquirer to set up an SPV by investing some equity and subsequently raising significant senior debt and mezzanine financing in the SPV, with the target company’s assets as security. Hence, India-based multinationals are able to avail themselves of funding to undertake outbound acquisitions that are not available for domestic acquisitions.

The Companies Act: Merger transactions in India are governed by the Companies Act, 1956, that sets forth a complex set of procedures in Sections 390–395. Domestic companies that aim to undertake a cross-border acquisition using a merger structure may be subject to the rules of the Companies Act, as well as the merger rules of the target entity’s jurisdiction.

The cumbersome and time-consuming merger process (i.e., prepare a “scheme” or “arrangement” of amalgamation, application to regional high court and creditor approval under the Companies Act) can take up to a year is. Therefore, outbound acquisitions using the merger structure are rare.

Takeover code: India's takeover code is biased towards the management and controlling shareholders. Given that laws in India are not sympathetic (indirect influence) to hostile takeovers, domestic firms have sought to make global acquisitions in a soft manner, after obtaining the buy-in of the potential target's management. In addition, domestic firms appear to be reluctant of an aggressive and hostile image.

Limitations of stock-swap transactions: A majority of the outbound M&A transactions by domestic companies have been structured as all-cash acquisitions of the target company, with only a few using shares as consideration. All cash deals are undertaken by utilising a part of existing cash reserves of the acquiring company and raising funds from global capital markets (owing to relaxed regulations to raise financing abroad).

India's complex regulatory regime (requirement of special resolution, valuation of shares, approval by the RBI and the Foreign Investment Promotion Board (FIPB)) imposes significant hurdles for domestic companies to use equity as consideration in an acquisition. In order to encourage and sustain the growth of Indian multinational companies, there is need to simplify procedures for outbound acquisitions.

Ceiling on Foreign Direct Investment (FDI): Despite the rapid liberalization of India's foreign investment regime in the early 1990s, impediments to FDI still exist in certain sectors of the economy. Sectoral caps for FDI continue in amongst others, defence production, retail, air transport services, ground handling services, asset reconstruction companies, private sector banking, broadcasting, commodity exchanges, credit information companies, insurance, print media, telecommunications and satellites, thus limiting the infusion of capital that is required for their growth and competitiveness.

Competition Act of 2002: The Competition Act of 2002 also mandates merger regulation. Any anti-competitive activity taking place outside India but having an appreciable adverse effect on competition within India will be subject to its application. Under the Act, the regulator is to resolve the reviews of applications within a period of 210 days, thus, adversely affecting time-sensitive deals.