Assured return on investments to a person resident outside India

Manendra Singh, Solicitor
India Private Equity Report

Quarterly

Apr-Jun 2016

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Data for this report is drawn exclusively from Venture Intelligence PE/VCDealDatabase:

- Access to PE/VC investments and exits tracked by Venture Intelligence since 1998
- Each deal captures name of the investee company, its location, Industry & Sector it operates in, the investors involved, the amount and date
- Includes information on the valuation and the advisors to the deal as available
- Financials of the target company
- Listing of PE/VC exits - both by IPO and M&A
- Access to PE/VC Directory of funds active in India
- Access to PE/VC-backed Company profiles
- Aggregate PE/VC statistics that includes data on deals that have been disclosed in confidence to Venture Intelligence
- Exportable to a user friendly and well formatted excel sheet

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Private Equity firms invested about $3,602 million across 129 deals during the quarter ended June 2016. The investment amount was 16% lower than that invested in the same period last year ($4,278 million across 169 transactions) and 7%lower than the immediate previous quarter ($3,890 million across 169 transactions). The latest figures take the PE investments in the first six months of 2016 to $7,492 million across 298 transactions - comparable to the first six months of 2016 which had witnessed $7,340 million across 370 deals. Note: These figures include Venture Capital investments, but exclude PE investments in Real Estate.

There were only six investments worth $100 million or more during Q2’16 compared to 11 such transactions in the same period last year and 12 during the immediate previous quarter.

**Highlights:**

- IT & ITES companies attract 43% of investments (by value)
- Buyouts accounts for 42% of investment pie
- 57% of the investments are below $5 million in size
- Median Investment value is $3 million, is lower compared to $4 million in the same period last year
Top Investments

Only six PE investments worth $100 million or more were reported during Q2’16 compared to 11 such transactions in the same period last year and 12 during the immediate previous quarter, the Venture Intelligence analysis showed. The largest PE investment announced during Q2’16 was Blackstone’s $1.1 billion buyout of the majority stake held by US-based Hewlett Packard Enterprise in IT Services & BPO firm Mphasis, which triggered an open offer to public shareholders of the target company. Sovereign Wealth Funds like Singapore’s GIC, Abu Dhabi’s ADIA and Malaysia’s Khazanah participated in mega investments for companies like the renewable power focused Greenko Group (that raised $230 million from ADIA and GIC) and analytics BPO firm Fractal Analytics ($100 million from Khazanah). Canada-based Fairfax Group committed a $300 million to chemicals manufacturer Sanmar Group (close on the heels of its $321 million bet in Bangalore International Airport announced in March).
By Industry

Led by the Mphasis and Fractal Analytics deals, IT & ITES companies accounted for 43% of the PE investment pie in Q2’16 attracting $1,564 million across 86 transactions. However, despite the blockbuster Mphasis transaction, the value of IT & ITES investments in Q2’16 was down 17% from the $1,889 million across 101 deals in the same period in 2015 (which had witnessed massive investments in Internet & Mobile companies led by Ola, Snapdeal and Quikr).

PE Investments by Industry Q2’16

<table>
<thead>
<tr>
<th>Industry</th>
<th>Volume</th>
<th>Value ($M)</th>
<th>% (Value)</th>
</tr>
</thead>
<tbody>
<tr>
<td>IT &amp; ITES</td>
<td>86</td>
<td>1564</td>
<td>43</td>
</tr>
<tr>
<td>Energy</td>
<td>2</td>
<td>730</td>
<td>20</td>
</tr>
<tr>
<td>BFSI</td>
<td>5</td>
<td>371</td>
<td>10</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>6</td>
<td>364</td>
<td>10</td>
</tr>
<tr>
<td>Healthcare &amp; Life Sciences</td>
<td>11</td>
<td>233</td>
<td>7</td>
</tr>
<tr>
<td>Others</td>
<td>19</td>
<td>341</td>
<td>10</td>
</tr>
</tbody>
</table>
By Stage

Buyouts, led by the Mphasis and ICICI Home Finance transactions, accounted for as much as 42% of the PE investment pie during Q2’16 – and were up 77% compared to the same period last year. Buyout investments at $1,503 million (across five transactions) was the only segment to witness a spike up over the same period in 2015.

Listed company investments ("PIPE" deals) accounted for 6% of the pie in value terms. Listed companies that attracted PE investments during the period was included Glenmark Pharma ($75 million from IFC) and cement maker Sanghi Industries ($39 million from Piramal Enterprises). Late Stage companies attracted 18 investments and accounted for 27% of the pie in terms of value during Q2’16.

The Venture Capital segment (defined as investments of up to $20 million in companies less than 10 years old) accounted for 94 of the PE transactions or 73% of volume pie during Q2’16 (9% by value). The VC investments of Q2’16 were dominated by Internet & Mobile companies like 1MG, Droom and Voonik.

<table>
<thead>
<tr>
<th>Stage</th>
<th>Volume</th>
<th>Value($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyout</td>
<td>5</td>
<td>1503</td>
</tr>
<tr>
<td>Late</td>
<td>18</td>
<td>974</td>
</tr>
<tr>
<td>Growth-PE</td>
<td>6</td>
<td>596</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>94</td>
<td>324</td>
</tr>
<tr>
<td>PIPE</td>
<td>6</td>
<td>205</td>
</tr>
</tbody>
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* Please see definitions at the end of the report
Fund Raising

**IDG Ventures India** raised $150 million (INR 1000 crores) from investors for its $200-million third fund named IDG Ventures India Fund III. **Matrix Partners India** topped up its existing $300-million India-dedicated fund by $110 million.

**ICICI Venture** made a first close of its 4th private equity fund India Advantage Fund Series 4 (IAF4) at approximately $190 million.

<table>
<thead>
<tr>
<th>First Investments* – India Dedicated Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor</td>
</tr>
<tr>
<td>Capital Optima</td>
</tr>
<tr>
<td>EVC Ventures</td>
</tr>
<tr>
<td>GSK Ventures</td>
</tr>
<tr>
<td>Katabole Technology Ventures</td>
</tr>
<tr>
<td>Max Ventures</td>
</tr>
<tr>
<td>MCube Capital</td>
</tr>
<tr>
<td>Next Orbit Ventures</td>
</tr>
<tr>
<td>Ninestarter</td>
</tr>
<tr>
<td>Rainmaker Ventures</td>
</tr>
</tbody>
</table>

*PE/VC Firms who made their first investments (since fund closing) during the period.*
### First Investments* – Global Funds

<table>
<thead>
<tr>
<th>Investors</th>
<th>Portfolio Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Romulus Capital</td>
<td>Vyome Biosciences</td>
</tr>
<tr>
<td>Chatsworth</td>
<td>Veqta</td>
</tr>
<tr>
<td>Grace Capital Ventures</td>
<td>Betaout</td>
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<tr>
<td>Man Capital</td>
<td>CollegeDekho.com</td>
</tr>
<tr>
<td>Motus Ventures</td>
<td>Auro Robotics</td>
</tr>
<tr>
<td>S-Squared Capital</td>
<td>Special Smile</td>
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<tr>
<td>Syven Capital</td>
<td>Tabtor</td>
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</tbody>
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* Foreign (i.e., non-India-dedicated) PE Firms who made their first investments in India during the period.

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## Legal Corner

### Assured Return On Investments To A Person Resident Outside India

#### Introduction

There are various reasons for which an investment is made by a foreign investor into an Indian company, the primary reason being the return on his investment. This article analyses whether the return on investment could be an assured return, and explains the legal provisions dealing with the concept of return on investment to a foreign investor in line with the provisions of the Foreign Exchange Management Act, 1999 (“FEMA”) read with the Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) Regulations, 2000 (“FEMA20”).

#### Concept of “Assured Return” and the provisions of FEMA

The FEMA and FEMA20 provides the manner in which foreign investment is made into an Indian company, and provides that there are various instruments that can be issued for the purpose of foreign direct investment (“FDI”) into Indian companies. Such instruments include equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares (in addition to warrants and partly-paid up shares) subject to pricing guidelines/valuation norms prescribed under FEMA20. It also provides the price at which transfer of shares should happen from resident to non-resident and vice-versa.

Interestingly, the concept of “assured return” was first brought to the fore by the Reserve Bank of India (“RBI”) vide the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Seventeenth Amendment) Regulations, 2013, dated 12 November 2013 (“17th Amendment”), which provided that shares or convertible debentures containing an optionality clause but without any option/right to exit at an assured price were reckoned as eligible instruments to be issued to a person resident outside India by an Indian company subject to the terms and conditions as specified in Schedule I of FEMA20.
Although the 17th Amendment was in the context of instruments with optionality clauses, it however, intended to provide the law in case a foreign investor is intending to exit his investment through the use of optionality clauses, that such exit needs to be at the price which was mentioned in the 17th Amendment, and such price could not have been to have a flavor of assured return to the foreign investor. The 17th Amendment did not explain the meaning of the expression “optionality clauses”, however, the Reserve Bank of India (“RBI”) circular A.P. (Dir Series) Circular No. 86 dated 9 January 2014 (“RBI Circular on Assured Return”) which came in furtherance of 17th Amendment, explained that the optionality clause will oblige the buy-back of securities from the investor at the price prevailing/value determined at the time of exercise of the optionality so as to enable the investor to exit without any assured return.

It is important to note that the RBI Circular further provided that all existing contracts will have to comply with the conditions provided in the RBI Circular on Assured Return to be FDI compliant. Though the 17th Amendment did not give the retrospective application to the validity of the instruments with optionality clauses, however, it seems that the language in the RBI Circular on Assured Return has given it a retrospective effect. The RBI Circular on Assured Return also did not provide for the timeline within which the agreements which had instruments with optionality clauses were required to be amended in order to be FDI compliant.

Further, the RBI Circular on Assured Return was amended vide circular A. P. (DIR Series) Circular No. 4 dated 15 July 2014 (“RBI Circular on Pricing”), which provided that in case of unlisted companies:

(i) the issue and transfer of shares including compulsorily convertible preference shares and compulsorily convertible debentures with or without optionality clauses shall be at a price worked out as per any internationally accepted pricing methodology on arm’s length basis; and

(ii) the guiding principle will be that the non-resident investor is not guaranteed any assured exit price at the time of making such investment/agreement and shall exit at a fair price computed as above at the time of exit subject to lock-in period requirement as applicable in terms of A.P. (DIR Series) Circular No. 86 dated January 9, 2014;

To ensure the accountability for the above, the RBI Circular on Pricing further provided that an Indian company taking on record in its books any transfer of its shares or convertible debenture by way of sale from a resident to a non-resident and a non-resident to a resident is required to disclose in its balance sheet for the financial year, in which the transaction took place, the details of valuation of share or convertible debentures, the pricing methodology adopted for the same as well as the agency that has given/certified the valuation.

A perusal of the abovementioned RBI Circulars, and 17th Amendment, recognises that when a foreign investor has invested into an Indian company by way of foreign direct investment in accordance with Schedule I of FEMA20, he should not be guaranteed an assured price for exit whether or not the instrument is with or without the optionality clause.

In the context of assured return, the Bombay High Court ruling in the case of IDBI Trusteeship
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*Services Ltd. v.s Hubtown Ltd*, is noteworthy. The case involved interesting set of facts whereby a foreign investor, through a complex transaction had subscribed to compulsory convertible debentures and 10% of the equity shares of an Indian holding company, which on conversion would entitle it to 99% shareholding. As predetermined, the Indian holding company further invested in two of its wholly owned subsidiaries by subscribing to optionally fully convertible debentures which carried a fixed coupon rate of 14.5%. The High Court observed that the structure was crafted to circumvent restrictions imposed under the FDI policy. Based on the fact that the Indian holding company was to receive a fixed return of 14.5% from its subsidiaries and that the foreign investor would hold 99% of Indian holding company post conversion, the High Court held that the foreign investor would receive an assured return which is not permitted under the FDI policy and FEMA Regulations.

The Court made the following observation:

“...The FDI policy and the statutory FEMA Regulations (which incorporates the FDI policy as a Schedule thereto) permit FDI in townships, construction of houses, only by way of equity investments (which is defined to also include debentures which are compulsorily required to be converted into equity: CCDs). The FDI policy and the FEMA Regulations prohibits any other form of investment (non equity) in the said sector with an assured return/ rate of return...”

**Concluding remarks**

In private equity transactions it is not uncommon to provide for a pre-agreed exit price clauses in the investment agreements. Private equity players do so to protect the value of their investment. Further, there have been cases where the Government has not been keen on allowing exits at pre-determined price to foreign investors, irrespective if the same would result in breach of contractual obligations between the parties. One of such cases is the case of Tata-Docomo, where permission was denied to exit at a pre-determined price by the Ministry of Finance after the Reserve Bank of India sought its views. However, interestingly, NTT Docomo has received an arbitration award on 23 June 2016 in its favour from the London Court of International Arbitration for USD 1.17 billion in compensation for breaching an agreement on India joint venture.

In view of the above discussion, it becomes important that the exit clauses in the agreements for investment, including Share Purchase/ Subscription Agreement and Shareholders’ Agreement are drafted properly so as to ensure that they comply with the provisions of the RBI circulars, that is, RBI Circular on assured Return, RBI Circular on Pricing and 17th Amendment. It is also important that such clauses which are in the nature of call and put are in compliance with notification issued by the Securities and Exchange Board of India dated on 3 October 2013.

**DISCLAIMER:** This article has been authored by Darshan Upadhyay, who is a Partner and Manendra Singh, who is an Associate Manager at Economic Laws Practice (ELP), Advocates

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1. (2015) 4 AIR Bom R 290

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Appendix 1: Definitions of Stages-of-company-development used:

Private Equity investments are classified into the following categories in this report.

**Venture Capital:**
First to Fourth Round of institutional investments into companies that are:
1) Less than <10 years old, AND
2) Investment amount is less than $20 M

**Growth-PE:**
1) First-to-Fourth Round Investments >$20 M into companies <10 years old, OR
2) Fifth / Sixth rounds of institutional investments into companies <10 years old

**Late Stage:**
1) Investment into companies that are over 10 years old, OR
2) Seventhor later rounds of institutional investments

**PIPEs:**
1) PE investments in publicly-listed companies via preferential allotments / private placements, OR
2) Acquisition of shares by PE firms via the secondary market

**Buyout:**
1) Acquisition of controlling stake via purchase of stakes of existing shareholders
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