Challenges Faced In Executing Leveraged Buyouts in India

The Evolution of the Growth Buyout

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I. INTRODUCTION

Merger and acquisition ('M&A') activity in India, though currently at its peak, is not as vibrant as that in the U.S. or Europe. M&A transactions tend to be financed largely by equity and / or cash. While debt-financed deals are a handful, financing of acquisitions using high-yield bonds is non-existent in India. Though the corporate debt market in India has been in existence since Independence, state-owned public sector undertakings account for nearly 80% of the primary market for debt issuances.

Commercial banks are among the most important players in the capital markets, especially in respect of debt financing. The dominance of the commercial banking system can be gauged from the fact that the proportion of bank loans to GDP is approximately 36%, while that of corporate debt to GDP is only 4%. By the same measure, the government securities market is nine to ten times as large as the corporate debt market. This is despite the fact that all major stock exchanges in India have trading platforms for debt securities.

In the past, Indian commercial banks have lent money to Indian companies for acquisition of government-owned companies slated for privatization. However, these transactions have been largely balance sheet financing, with Indian banks favoring the traditional asset-backed and balance sheet financing.

It is important to note that India has a large private sector, which regularly taps the capital markets, in India as well in the U.S. and Europe, for its financing requirements. There is a developed government securities market with a yield curve, which can provide a reliable benchmark for the pricing of leveraged debt and all major stock exchanges in India have trading platforms for debt securities. The reasons for the under-development of the debt market and the relative lack of leveraged buyouts in India are much more profound than meets the eye.

This paper identifies and explains the reasons that make execution of leveraged buyouts in India difficult in the current environment. This paper also examines recent leveraged buyouts and explains how the factors identified affect leveraged buyouts in India.

II. LEVERAGED BUYOUTS

A leverage buyout ('LBO') is the acquisition of a business, typically a mature company, by a financial investor whose objective is to exit the investment after 3-7 years realizing an Internal Rate of Return ('IRR') of in excess of 20% on its investment over the horizon.

The term **'Leveraged'** signifies a significant use of debt for financing the transaction. The purpose of a LBO is to allow an acquirer to make large acquisitions without having to commit a significant amount of capital. A typically transaction involves the setup of an acquisition vehicle that is jointly funded by a financial investor and management of the target company. Often the assets of the target company are used as collateral for the debt. Typically, the debt capital comprises of a combination of highly structured debt instruments including prepayable bank facilities and / or publicly or private placed bonds commonly referred to as high-yield debt.

Table 1: Typical financial instruments used for financing a LBO

Components of capital	*% of total capital*	*Tenure (years)*	*Traditional suppliers of capital*
Senior debt			
Revolving	30%-60%	5-8	Investment bank
Term			Commercial bank
Subordinated debt			
Senior / subordinated notes	10%-25%	7-10	Investment bank
Discount notes			Commercial bank
Traditional mezzanine		9-10	Mezzanine fund
Preferred stock / Mezzanine securities			
Preferred stock	0%-35%	7-10+	Investment bank
			Commercial bank
Pay-In-Kind ('PIK') debt			Mezzanine fund
Warrants			
Common equity			
Common equity	25%-40%	3-7	Private equity fund
Vendor loan notes (deeply subordinated)		10-12	Vendor loan notes

The new debt in a LBO is not intended to be permanent. LBO business plans call for generating extra cash by selling assets, shaving costs and improving profit margins. The extra cash is used to pay down the LBO debt. Managers are given greater stake in the business via stock options or direct ownership of shares.

The term **'Buyout'** suggests the gain of control of a majority of the target company's equity. The target company goes private after a LBO. It is owned by a partnership of private investors who monitor performance and can act right away if something goes awry. Again, the private ownership is not intended to be permanent. The most successful LBOs go public again as soon as debt has been paid down sufficiently and improvements in operating performance have been demonstrated by the target company.

Target companies that have the following operating and financial characteristics are considered ideal LBO targets:

Table 2: Typical operating and financial characteristics of attractive LBO targets

Operating characteristics	***Financial Characteristics***
Leading market position - proven demand for product	Significant debt capacity
Strong management team	Steady cash flow
Portfolio of strong brand names (if applicable)	Availability of attractive price
Strong relationships with key customers and suppliers	Low capital intensity
Favorable industry characteristics	Potential operating improvement
Fragmented industry	Ideally low operating leverage
Steady growth	Management's success in implementing substantial cost reduction programmes

III. MACRO FACTORS MAKING LEVERAGED BUYOUTS DIFFICULT IN INDIA

This paper distinguishes between buyouts of Indian companies from those buyouts where an Indian company does a LBO of a foreign target company, with the intention of analyzing the former. The reason for making this distinction and restricting the scope of this paper to buyouts of Indian companies is, in the case of LBOs where the target company is located in countries such as the United Kingdom or the United States, the acquiring Indian companies / financial investors are able to obtain financing for the leveraged buyouts from foreign banks and the buyout is governed largely by the laws and regulations of the target company's country.

On the other hand, a leveraged buyout of an Indian company by either an Indian or a foreign acquirer needs to comply with the legal framework in India and the scope of execution permissible in India. This section of the paper examines the legal and regulatory hurdles to a successful LBO of an Indian company.

India has experienced a number of buyouts and leveraged buyouts since Tata Tea's LBO of UK heavyweight brand Tetley for ₤271 million in 2000, the first of its kind in India.

Table 3: List of buyouts by Indian companies

Target Company	***Country***	***Indian Acquirer***	***Value***	***Type***
Tetley	United Kingdom	Tata Tea	₤271 million	LBO
Whyte & Mackay	United Kingdom	UB Group	₤550 million	LBO
Corus	United Kingdom	Tata Steel	$11.3 billion	LBO
Hansen Transmissions	Netherlands	Suzlon Energy	€465 million	LBO
American Axle[1]	United States	Tata Motors	$2 billion	LBO
Lombardini[2]	Italy	Zoom Auto Ancillaries	$225 million	LBO

[1] Potential bid [2] Buyout attempt

Table 4: List of buyouts of Indian companies

Company	*Financial investor*	*Value*	*Type*
Flextronics Software Systems[1]	Kohlberg Kravis Roberts & Co. ('KKR')	$900 million	LBO
GE Capital International Services ('GECIS')	General Atlantic Partners, Oak Hill	$600 million	LBO
Nitrex Chemicals	Actis Capital	$13.8 million	MBO[2]
Phoenix Lamps	Actis Capital	$28.9 million[3]	MBO
Punjab Tractors[4]	Actis Capital	$60 million[5]	MBO
Nilgiris Dairy Farm	Actis Capital	$65 million[6]	MBO
WNS Global Services	Warburg Pincus	$40 million[7]	BO
RFCL (businesses of Ranbaxy)	ICICI Venture	$25 million	LBO
Infomedia India	ICICI Venture	$25 million	LBO
VA Tech WABAG India	ICICI Venture	$25 million	MBO
ACE Refractories (refractories business of ACC)	ICICI Venture	$60 million	LBO
Nirula's	Navis Capital Partners	$20 million	MBO

1 Renamed Aricent. Referred to as Flextronics Software Systems throughout this paper.
2 Management Buyout ('MBO')
3 Paid for 36.7% promoter stake. Post the open offer, Actis' stake will increase from 45% to 65%.
4 Government privatization.
5 Total controlling interest of 28.4%. Punjab Tractors continues operating as a publicly listed company.
6 Paid for 65% controlling stake. Balance held by the promoter family.
7 Purchase of an 85% stake from British Airways

III.1 Restrictions on Foreign Investments in India

There are 2 routes through which foreign investments may be directed into India – the Foreign Institutional Investor ("FII") route and the Foreign Direct Investment ("FDI") route.

The FII route is generally used by foreign pension funds, mutual funds, investment trusts, endowment funds and the like to invest their proprietary funds or on behalf of other funds in equities or debt in India. Private equity firms are known to use to FII route to make minority investments in Indian companies. The FDI route is generally used by foreign companies for setting up operations in India or for making investments in publicly listed and unlisted companies in India where the investment horizon is longer than that of an FII and / or the intent is to exercise control.

III.1.A **Limits on FII Investment**

The Government of India has laid down investment limits for FIIs of 10% based on certain requirements and the maximum FII investment in each publicly listed company, which may at times be lower than the sectoral cap for foreign investment in that company. For example, the sectoral cap on foreign investment in the telecom sector is 100%. However, cumulative FII investment in an Indian telecom company would be subject to a ceiling of 24% or 49%, as the case may be, of the issued share capital of the said telecom company.

III.1.B **Restrictions and Caps and Foreign Investment Promotion Board ('FIPB') Approval**

Sectors where FDI is not permitted are Railways, Atomic Energy and Atomic Minerals, Postal Service, Gambling and Betting, Lottery and basic Agriculture or plantations with specified exceptions. Further, the Government has placed sector caps on ownership by foreign corporate bodies and individuals in Indian companies and 100% foreign ownership is not allowed in a number of industry sub-sectors under the current FDI regime.

Further, under the FDI route, FIPB approval is required for foreign investments where the proposed shareholding is above the prescribed sector cap or for investment in sectors where FDI is not permitted or where it is mandatory that proposals be routed through the FIPB [Refer Appendix I for industry-wise sector caps].

III.1.C **Regulatory Developments in FDI**

Despite the detailed guidelines for foreign investment in India, regulations relating to foreign investment continue to get formulated as the country gradually opens its doors to global investors. The evolving regulatory environment coupled with the lack of clarity about future regulatory developments create significant challenges for foreign investors.

For example, the Indian government lifted a ban on foreign ownership of Indian stock exchanges just three weeks before the NYSE Group, Goldman Sachs and other investors bought a 20% stake in the National Stock Exchange of India. At the time of lifting the ban, the Indian Government allowed international investors to buy as much as a combined 49% (FDI up to 26% and FII investment of up to 23%) in any of the 22 Indian stock exchanges. The limit for a single investor was set at 5% by the Securities and Exchange Board of India ('SEBI').

III.1.D List of Sectors where FDI Limit is Less Than 100%

The following table summarizes the list of sectors where the FDI limit is less than 100%.

Table 5: List of sectors where the FDI limit is less than 100% (as of February 26, 2006)

Sector	*Ownership Limit*	*Entry Route*
Domestic Airlines	49%	Automatic
Petroleum refining-PSUs	26%	FIPB
PSU Banks	20%	
Insurance	26%	Automatic
Retail Trade	51%	FIPB
Trading (Export House, Super Trading House, Star Trading House)	51%	Automatic
Trading (Export, Cash and Carry Wholesale)	100%	FIPB
Hardware facilities - (Uplinking, HUB, etc.)	49%	
Cable network	49%	
Direct To Home	20%	
Terrestrial Broadcast FM	20%	
Terrestrial TV Broadcast	Not Permitted	
Print Media - Other non-news/non-current affairs/specialty publications	74%	
Newspapers, Periodicals dealing with news and current affairs	26%	
Lottery, Betting and Gambling	Not Permitted	
Defense and Strategic Industries	26%	FIPB
Agriculture (including contract farming)	Not Permitted	
Plantations (except Tea)	Not Permitted	
Other Manufacturing - Items reserved for Small Scale	24%	Automatic
Atomic Minerals	74%	FIPB

Source: Investment Commission of India

III.1.E Key Advantages and Disadvantages of the Investment Routes

The key advantages and disadvantages of investments made through these routes are summarized below:

Table 6: Key advantages and disadvantages of the FDI and FII routes of investment

FDI	*FII*
Advantages	**Advantages**
▪ FDI route used when foreign investment is in excess of 10%. ▪ Allotment of shares on preferential basis as per the requirements of the Companies Act, 1956, possible. ▪ Off-market / Non-stock exchange purchases may be executed. ▪ FDI is the only route available for investing in unlisted companies in India. ▪ Automatic approval for FDI for investments in specified sectors based on the FDI guidelines.	▪ Ability to buy and sell securities freely on a stock exchange. ▪ The total investments by FII and Sub-Accounts in any Indian Company cannot exceed 24% of its total paid up capital. However, in certain companies, which have passed a Special Resolution in this regard, the total FII investment can be made upto 49% of the paid up capital. This limit of 24% / 49% is exclusively available for investments by FII only.
Disadvantages	**Disadvantages**
▪ FDI sector caps as per the Government FDI policy. ▪ FIPB approval required for investment in specified sectors.	▪ SEBI acts as the nodal point in the registration of FIIs. FII registration is a cumbersome process which involves registration with SEBI and approval from the Reserve Bank of India ('RBI'). ▪ FIIs are heavily regulated by SEBI through the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995. ▪ No FII can hold more than 10% of the share capital of any publicly listed company. ▪ All non-stock exchange sales/purchases require RBI permission.

Despite the various restrictions on foreign investment in Indian companies, the FDI route is the only feasible route for leveraged buyouts in India by foreign investors.

***III.2* Limited Availability of Control Transactions and Professional Management**

Private equity firms face limited availability of control transactions in India. The reason for this is the relative small pool of professional management in corporate India. In a large number of Indian companies, the owners and managers are the same. Management control of such target companies wrests with promoters / promoter families who may not want to divest their controlling stake for additional capital. As a result, a large number of private equity transactions in India are minority transactions [Refer Appendix VI for recent minority private equity transactions in India].

In management buyouts, the Indian model is different from that in the West. Most of the MBOs in India are not of the classic variety wherein the company's managements create the deal and then involve financial investors to fund the change of control. In the Indian version, promoters have spun off or divested and private equity players have bought the businesses and then partnered with the existing management. The managements themselves don't have the resources to engineer such a buyout.

In the absence of control, it may be difficult to finance a minority investment using leverage given the lack of control over the cash flows of the target company to service the debt. Further, a minority private equity investor will be unable to sell it's holding to a strategic buyer, thereby limiting the exit options available for the investment.

***III.3* Underdeveloped Corporate Debt Market**

India is a developing country where the dependence on bank loans is substantial. The country has a bank-dominated financial system. The dominance of the banking system can be gauged from the fact that the proportion of bank loans to GDP is approximately 36%, while that of corporate debt to GDP is only 4%. As a result, the corporate bond market is small and marginal in comparison with corporate bond markets in developed countries.

The corporate debt market in India has been in existence since Independence. Public limited companies have been raising capital by issuing debt securities in small amounts. State-owned public sector undertakings (‘PSU’) that started issuing bonds in financial year 1985-86 account for nearly 80% of the primary market. When compared with the government securities market, the growth of the corporate debt market has been less satisfactory. In fact, it has lost share in relative terms.

Table 7: Resources raised from the debt markets *INR billion*

Financial Year	*2000-01*	*2001-02*	*2002-03*	*2003-04*	*2004-05*
Total debt raised	1,850.56	2,040.69	2,350.96	2,509.09	2,050.81
Of which: Corporate[1]	565.73	515.61	531.17	527.52	594.79
	31%	*25%*	*23%*	*21%*	*29%*
Of which: Government	1,284.83	1,525.08	1,819.79	1,981.57	1,456.02
	69%	*75%*	*77%*	*79%*	*71%*

[1] Excludes euro issues
Sources: RBI, NSE, Prime Database

Another noteworthy trend in the corporate debt market is that a bulk of the bulk of debt raised has been through private placements. During the five years 2000-01 to 2004-05, private placements, on average, have accounted for nearly 92% of the total corporate debt raised annually. The dominance of private placements has been attributed to several factors, including ease of issuance, cost efficiency and primarily institutional demand. PSUs account for the bulk of private placements. The corporate sector has accounted for less than 20% of total private placements in recent years, and of that total, issuance by private sector manufacturing/services companies has constituted only a very small part. Large private placements limit transparency in the primary market.

Another interesting feature of the Indian corporate debt market is the preference for rated paper. Ratings issued by the major rating agencies have proved to be a reliable source of information. The data on ratings suggest that lower-quality credits have difficulty issuing bonds. The concentration of turnover in the secondary market also suggests that investors' appetite is mainly for highly rated instruments, with nearly 84% of secondary market turnover in AAA-rated securities. In addition, the pattern of debt mutual fund holdings on 30 June 2004 showed that nearly 53.3% of non-government security investments were held in AAA-rated securities, 14.7% in AA-rated securities and 10.8% in P1+ rated securities.

This is in sharp contrast to the use of high-yield bonds (also known as junk bonds) which became ubiquitous in the 1980s through the efforts of investment bankers like Michael Milken, as a financing mechanism in mergers and acquisitions. High-yield bonds are non-investment grade bonds and have a higher risk of defaulting, but typically pay high yields in order to make them attractive to investors. Unlike most bank debt or investment grade bonds, high-yield bonds lack 'maintenance' covenants whereby default occurs if financial health of the borrower deteriorates beyond a set point. Instead, they feature 'incurrence' covenants whereby default only occurs if the borrower undertakes a prohibited transaction, like borrowing more money when it lacks sufficient cash flow coverage to pay the interest.

The following table compares the corporate bond spreads in the US those in India. The bonds spreads for Indian companies in the low investment grade and non-investment grade bonds are clearly influenced by the limited number of such bonds in circulation and the lack of liquidity in those segments of the corporate debt market.

Table 8: Comparison of bond spreads of US Industrial companies with Indian companies

	AAA	AA	A+	A	A-	BBB+	BBB	BBB-
US Industrial companies (Nov 30, 2006)								*basis points*
1 Year	27	33	37	41	53	61	72	77
2 Years	34	41	42	46	55	63	72	91
3 Years	48	53	55	59	67	73	81	100
4 Years	59	64	67	70	77	83	93	112
5 Years	60	67	69	70	79	87	101	131
7 Years	49	56	64	68	78	87	106	144
8 Years	62	65	69	72	82	87	104	140
9 Years	73	77	83	87	97	102	110	146
10 Years	61	65	72	75	87	107	126	152
Indian companies (Oct 31, 2006)								*basis points*
1 Year	85	113	143	161	181	211	247	287
2 Years	94	120	149	167	186	214	252	292
3 Years	93	121	153	175	193	223	265	308
4 Years	95	124	155	177	195	224	267	311
5 Years	97	128	158	179	197	226	270	314
7 Years	104	131	163	185	203	238	285	332
8 Years	106	134	166	189	207	241	289	337
9 Years	108	137	170	192	212	244	293	341
10 Years	110	140	173	196	216	247	297	346

Source: Bloomberg and Fixed Income Money Market and Derivatives Association of India

The use of credit derivatives allows lenders to transfer an asset's risk and returns from one counter party to another without transferring the ownership. The credit derivatives market is virtually non-existent in India due to the absence of participants on the sell-side for credit protection and the lack of liquidity in the bond market.

Indian enterprises now have the ability to raise funds in foreign capital markets. Indeed, an underdeveloped domestic market pushes the better-quality issuers abroad, thereby accentuating the problems of developing the corporate debt market in India. All these drawbacks of the Indian corporate debt market make the use of the domestic debt market for financing leveraged buyouts in India virtually impossible.

III.4 **Reserve Bank of India ('RBI') Restrictions on Lending**

Domestic banks are prohibited by the RBI from providing loans for the purchase of shares in any company. The underlying reason for the prohibition is to ensure the safety of domestic banks. The RBI has issued a number of directives to domestic banks in regard to making advances against shares. These guidelines have been compiled in the Master Circular Dir.BC.90/13.07.05/98 dated August 28, 1998. As per these guidelines, domestic banks are not allowed to finance the promoters' contribution towards equity capital of a company, the rationale being that such contributions should come from the promoters' resources.

The RBI Master Circular states that the question of granting advances against primary security of shares and debentures including promoters' shares to industrial, corporate or other borrowers should not normally arise. The RBI only allows accepting such securities as collateral for secured loans granted as working capital or for other 'productive purposes' from borrowers. [Refer Appendix IV for an extract of the Master Circular]

The RBI has made an exception to this restriction. With the view to increasing the international presence of Indian companies, with effect from June 7, 2005, the RBI has allowed domestic banks to lend to Indian companies for purchasing equity in foreign joint ventures, wholly owned subsidiaries and other companies as strategic investments. Besides framing guidelines and safeguards for such lending, domestic banks are required to ensure that such acquisitions are beneficial to the borrowing company and the country.

Besides raising financing from Indian banks, companies have the option of funding overseas acquisitions through External Commercial Borrowings ('ECBs'). The Indian policy on ECBs allow for overseas acquisitions within the overall limit of US$500 million per year under the automatic route with the conditions that the overall remittances from India and non-funded exposures should not exceed 200% of the net worth of the company.

The Reserve Bank of India has prescribed that a bank's total exposure, including both fund based and non-fund based, to the capital market in all forms covering

(a) direct investment in equity shares,
(b) convertible bonds and debentures and units of equity oriented mutual funds;
(c) advances against shared to individuals for investment in equity shares (including IPOs), bonds and debentures, units of equity-oriented mutual funds; and
(d) secured and unsecured advances to stockbrokers and guarantees issued on behalf of stockbrokers and market makers

should not exceed 5% of its total outstanding advances as on March 31 of the previous year (including Commercial Paper). Within the above ceiling, bank's direct investment should not exceed 20% of its net worth.

All these restrictions make it virtually impossible for a financial investor to finance a LBO of an Indian company using bank debt raised in India.

III.5 Prohibition on Borrowing from Indian Banks – FIPB Press Note 9

A somewhat arcane regulation, FIPB's Press Note 9 dated April 12, 1999 bars a foreign investment company from borrowing from an Indian bank to buy into a company in India.

Large banks – foreign as well as local – some multinational companies and a few private equity players have been lobbying with the Indian Government to change this rule. While bankers in India believe that they should have the freedom to invest in a wider number of asset classes, foreign investors argue that dismantling the norm will not only raise the return on the equity they contribute in, but also make it possible for them to pay a higher price for the shares of local companies they buy.

The subject has assumed a deeper significance with the advent of a large number of private equity players - which are technically foreign investment companies, and thus cannot borrow from banks in India to invest in local firms. Whatever the private equity players invest is either pure equity or FDI cleared by the FIPB. This regulation clearly stands in the way of leveraged buyouts of Indian companies by foreign private equity firms. The World Economic Forum is also understood to have drawn the Indian Government's attention to Press Note 9. [Refer Appendix III for a copy of Press Note 9]

III.6 **Restrictions on Public Companies from Providing Assistance to Potential Acquirers**

Companies Act, 1956, Section 77(2) states that a public company (or a private company which is a subsidiary of a public company) may not provide either directly or indirectly through a loan, guarantee or provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company or in its holding company.

Under the Companies Act, 1956, a public company is different from a publicly listed company. The restrictions placed by this section on public companies implies that prior to being acquired in a LBO, a public company, if it is listed, must delist and convert itself to a private company. Delisting requires the Company to follow the Securities and Exchange Board of India (Delisting of Securities) Guidelines – 2003. This section makes it impossible to obtain security of assets / firm financing arrangements for a publicly listed company until it delists itself and converts itself into a private company.

III.7 Restrictions Relating to Exit Through Public Listing

The most successful LBOs go public as soon as debt has been paid down sufficiently and improvements in operating performance have been demonstrated by the LBO target.

SEBI guidelines require mandatory listing of Indian companies on domestic exchange prior to a foreign listing. Indian companies may list their securities in foreign markets through the Issue Of Foreign Currency Convertible Bonds And Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993. Prior to the introduction of this scheme, Indian companies were not permitted to list on foreign bourses.

In order to bring these guidelines in alignment with the SEBI's guidelines on domestic capital issues, the Government incorporated changes to this scheme by requiring that an Indian company, which is not eligible to raise funds from the Indian capital markets including a company which has been restrained from accessing the securities market by the SEBI will not be eligible to issue ordinary shares through Global Depository Receipts ('GDR'). Unlisted companies, which have not yet accessed the GDR route for raising capital in the international market would require prior or simultaneous listing in the domestic market, while seeking to issue ordinary shares under the scheme. Unlisted companies, which have already issued GDRs in the international market, would now require to list in the domestic market on making profit beginning financial year 2005-06 or within three years of such issue of GDRs, whichever is earlier.

Thus, private equity players that execute a LBO of an Indian company and are looking at exiting their investment will require dual listing of the company – on a domestic stock exchange as well as a foreign stock exchange – if they intend to exit the investment through a foreign listing.

SEBI listing regulations require domestic companies to identify the promoters of the listing company for minimum contribution and promoter lock-in purposes. In case of an IPO, the promoters have to necessarily offer at least 20% of the post-issue capital. In case of public issues by listed companies, the promoters shall participate either to the extent of 20% of the proposed issue or ensure post-issue share holding to the extent of 20% of the post-issue capital.

Further, SEBI guidelines have stipulated lock-in (freeze on the shares) requirements on shares of promoters primarily to ensure that the promoters, who are controlling the company, shall continue to hold some minimum percentage in the company after the public issue. In case of any issue of capital to the public the minimum contribution of promoters shall be locked in for a period of three years, both for an IPO and public issue by listed companies. In case of an IPO, if the promoters' contribution in the proposed issue exceeds the required minimum contribution, such excess contribution shall also be locked in for a period of one year. In addition, the entire pre-issue share capital, or paid up share capital prior to IPO, and shares issued on a firm allotment basis along with issue shall be locked-in for a period of one year from the date of allotment in public issue.

For a private equity investor in a LBO of an Indian company, the IPO route does not allow the investor a clean exit from its investment due to the minimum promoter contribution and lock-in requirements.

Besides these drawbacks, there are other factors that play an important role in exiting a LBO in India. Exit through the public markets depends upon the target company’s operations. If the operations are located solely in India, sale in the domestic public markets is most lucrative. If the portfolio company has operations or an export presence in foreign markets, it may be more beneficial to list the company in foreign capital markets.

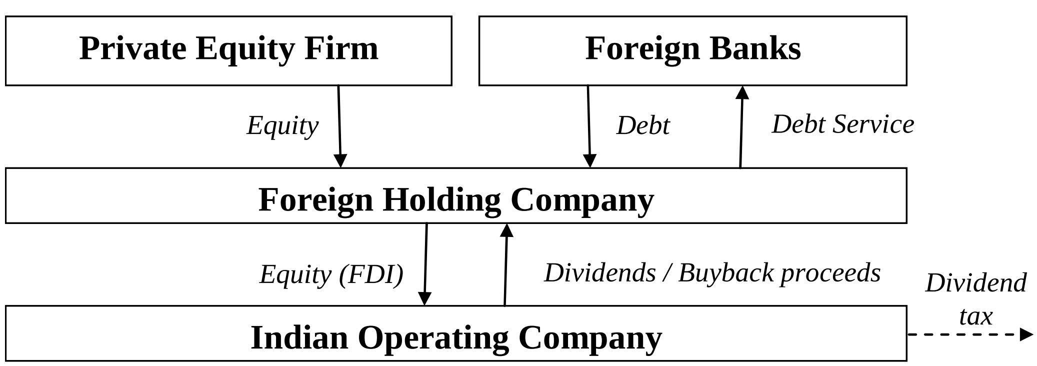
IV. STRUCTURING CONSIDERATIONS FOR LEVERAGED BUYOUTS IN INDIA

The hurdles to executing a LBO in India, as discussed in the previous section, has given rise to two buyout structures, referred to in this paper as the Foreign Holding Company Structure and the Asset Buyout Structure, that may be used for effecting a LBO of an Indian company. However, both these structures are rife with their own set of challenges that are unique to the Indian environment. The Holding Company and the Asset Buyout structures along with key considerations / drawbacks are discussed as follows.

IV.1 Foreign Holding Company Structure

The financial investor incorporates and finances (using debt and equity) a Foreign Holding Company. Debt to finance the acquisition is raised entirely from foreign banks. The proceeds of the equity and debt issue is used by the Foreign Holding Company to purchase equity in the Indian Operating Company in line with FIPB Press Note 9. The amount being invested to purchase a stake in the India Operating Company is channeled into India as FDI. The seller of the Indian Operating Company may participate in the LBO and receive securities in the Foreign Holding Company as part of the payment, such as rollover equity and seller notes.

Figure 1: Illustrative Foreign Holding Company Structure



The operating assets of the purchased business are within the corporate entity of the Indian Operating Company. As a result, cash flows are generated by the Indian Operating Company while principal and interest payment obligations reside in the Foreign Holding Company. The Indian Operating Company makes dividend or share buyback payments to the Foreign Holding Company, which is used by the latter for servicing the debt. Under the current FDI regime foreign investments, including dividends declared on foreign investments, are freely repatriable through an Authorized Dealer. [Refer Appendix V for buyout structure of Flextronics Software Systems]

IV.1.A **Lien on Assets**

Based on the LBO structure above, the debt and the operating assets lie in two separate legal entities. The Indian Operating Company is unable to provide collateral of its assets for securing the debt which resides in the Foreign Holding Company. While this feature of the Foreign Holding Company Structure may be anathema for lenders looking at providing secured debt for the LBO, it may be of less significance when the LBO target is an asset-light business such as a business process outsourcing or a information technology services company. Investing in a services company may be a rational strategy of using this LBO structure.

Financial investors may consider legally placing certain assets of the business in the Foreign Holding Company, such as customer contracts of a business process outsourcing or information technology services company. These assets may be used as collateral and generate operating income for the Foreign Holding Company. Contracts between the Foreign Holding Company and the Indian Operating Company will have to satisfy India’s transfer pricing regulations.

IV.1.B Non-deductibility of Interest Payments

Given that the debt and the operating assets reside in separate legal entities, there is no deduction of interest payments from operating income of the Indian Operating Company. One of the financial justifications for a LBO is lost under this structure. However, this factor assumes less significance for export-oriented companies which operate out of Special Economic Zones or Software Technology Parks (under the Software Technology Park scheme) in India and avail tax incentives which lowers their effective tax rate significantly.

IV.1.C Foreign Currency Risk

The Foreign Holding Company structure entails an exposure to foreign currency risk since revenues of the Indian Operating company are denominated in Indian Rupees and the debt in the Foreign Holding Company is denominated in foreign currency. The foreign currency risk may be hedged in the financial markets at a cost, which increases the overall cost of the LBO. Alternatively, if the Indian Operating Company's revenues are denominated primarily in foreign currency due to an export-focus, this risk is mitigated due to the natural hedge provided by foreign currency denominated revenues.

IV.1.D Tax Leakage through Dividend Tax

There is tax leakage under the Foreign Holding Company structure through mandatory dividend tax payments on dividends paid by the Indian Operating Company to service the debt of the Foreign Holding Company. As per Budget 2007 introduced for the financial year 2007-2008, Dividend Distribution Tax rate has increased from 12.5% to 15%.

IV.1.E Restrictions Relating to Share Buyback

Often, the Indian Operating Company may make remittances to the Foreign Holding Company through share buybacks instead of dividends. The number of shares and size of buybacks are governed by the Companies Act, 1956. Section 77A of the Act allows companies to buyback shares. However, the provisions for the buyback of shares comes with certain conditions, which are detailed as follows:

(a) A company may buyback share only out of free reserves, the securities premium account or from the proceeds of any different kind of shares or other specified securities. This condition puts a restriction on the amount of the buyback based on the balance sheet of the target company.

(b) No offer of buyback shall be made within a period of 365 days reckoned from the date of the last offer of buy-back. As a result, companies may buyback its own shares only once every year.

(c) The buyback of equity shares in any financial year cannot exceed 25% of its total paid-up (book) equity capital in that financial year. Similar to (a) above, this condition puts a limit on the number of shares that can be bought back in each financial year.

(d) The ratio of the debt owed by the company is not more than twice the (book) capital and free reserves after such buy-back. This condition is critical to structuring the LBO. In the Foreign Holding Company structure this condition puts a limit of the amount of debt that may be assumed by the Indian Operating Company. The amount of debt in the Indian Operating Company puts a limit of the amount of shares that may be bought back. Thus, there is a trade-off between the size of the buyback and the amount of debt that may be raised by the Indian Operating Company.

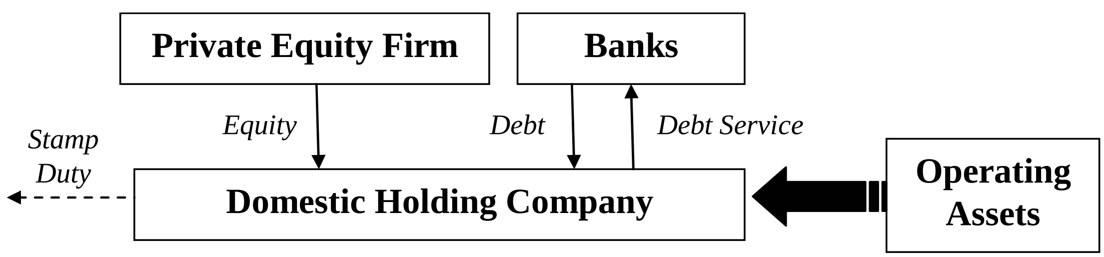
IV.1.F Facilitation of Exit Through Foreign Listing

The Foreign Holding Company structure allows the financial investor to list the holding company domiciled in a foreign jurisdiction on a US / European stock exchange without listing the Indian Operating Company on the Indian stock exchange. This provides the financial investor a clean exit from the investment.

IV.2 **Asset Buyout Structure**

Under an Asset Buyout, the financial investor incorporates a Domestic Holding Company and finances it using debt and equity. The debt is raised based on an purchase agreement to buy operating assets and is secured by those assets, since asset-backed, project loans and secured working capital loans is permissible for domestic banks in India. The Domestic Holding Company then purchases the operating assets of the business on an asset-by-asset basis e.g. land, building, machinery etc. Foreign investors may invest in the equity of the Domestic Holding Company through the FDI route.

Figure 2: Illustrative Asset Buyout Structure



IV.2.A **Stamp Duty Liability and Execution Risk**

In an Asset Buyout structure, the Domestic Holding Company which is buying the operating assets is liable to pay stamp duty on the assets purchased. Stamp duty adds an additional 5-10% to the total transaction cost depending upon the assets purchased and Indian state in which stamp duty is assessed, since different states have different rates of stamp duty. Further, the purchase of assets requires the purchaser to identify and value each of the assets purchased separately for the purpose of assessment by the relevant authorities e.g. land, building, machinery etc as each such asset has a separate rate of stamp duty. A LBO of an asset-intensive company may make the transaction unfeasible.

The identification and valuation of individual assets purchased along with assessment of the stamp duty by the relevant authorities involves complex structuring of the transaction making the execution of this structure complex and risky.

IV.2.B Higher Tax Liability for Seller

The purchase and sale of shares of a company (as envisaged by the Foreign Holding Company Structure) attracts Securities Transaction Tax (0.125%) for listed shares and Long Term Capital Gains Tax (10-20%). However, sale of assets by the seller is treated as a revenue by the Income Tax Act, 1956 and such gain is assessed as business income on which the tax rate is 30% to be increased by a 10% surcharge and an education cess of 3% (34% effective tax rate).

V. HYPOTHETICAL FINANCIAL MODEL OF A LEVERAGED BUYOUT IN INDIA

I have constructed a financial model of a leveraged buyout in India for a hypothetical business process outsourcing company. The operating and financial characteristics of the company are loosely based on those of the LBO of Flextronics Software Systems by KKR using information available from public sources, to the extent available. However, this model may not be considered representative of Flextronics Software Systems or its LBO given the limited availability of financial information since it went private in 2005.

V.1 Key Inputs and Assumptions

The key inputs used in the model are elaborated as follows:

Table 9: Hypothetical Opening Balance Sheet

($ in millions) **Consolidated Opening Balance Sheet**	**Pre-Transaction**
Accounts Receivable	25.0
Prepaid & Other Assets	20.0
Total Current Assets	$45.0
PP&E	$25.0
Total Assets	**$70.0**
Current Liabilities & Provisions	$30.0
Common Equity	$2.0
Retained Earnings	$38.0
Shareholders' Equity	$40.0
Total Liabilities & Shareholders' Equity	**$70.0**

Table 10: Hypothetical Income Statement in Year 1

($ in millions) **Income Statement**	**Year 1**
Total Revenues	100.0
Cost of Goods Sold	(32.0)
Gross Profit	$68.0
Operating Expenses	($20.0)
EBITDA	48.0
Depreciation & Amortization	($8.0)
Capital Expenditures	(12.0)

Table 11: Sources and Uses of Funds

($ in millions)

Sources of Funds	Without Stamp Duty	With Stamp Duty	Uses of Funds	Without Stamp Duty	With Stamp Duty
Revolving Credit Facility (1)	$0.0	$0.0	Purchase Price	$540.0	$540.0
Term Loan	155.0	155.0	Estimated Fees and Expenses	20.0	75.0
Seller Notes	130.0	130.0			
Equity Contribution	275.0	330.0			
Total Sources	$560.0	$615.0	Total Uses	$560.0	$615.0

(1) Total commitment of $30.0 million.

Operating Assumptions for the projection period are as follows:

- Revenue growth of 20% (Years 2 and 3), 15% (Years 4 to 6) and 10% (Year 7 to 8);
- Gross margins of 60% (Years 1 to 3), 55% (Years 4 to 6) and 50% (Year 7 to 8);
- EBITDA margins of 40% (Years 1 to 3), 35% (Years 4 to 6) and 30% (Year 7 to 8);
- Depreciation and capital expenditures at 8% and 12% of total revenues respectively;
- The Revolving Credit Facility and the Term Loan is priced at LIBOR + 300 basis points;
- The Revolving Credit Facility commitment fee is 0.5%;
- The Seller Notes carry a 11% Pay-In-Kind ('PIK') coupon;
- Financing costs are written off over a period of 7 years;
- Components of net working capital as a % of revenue / cost of goods sold are constant;
- The effective tax rate for the Company is 10% through the projection period;
- Dividend Distribution Tax is 15% based on the Budget for 2007;
- Foreign currency risks and hedging costs have been ignored;
- Stamp duty paid under the Asset Buyout Structure, assumed at 10% of the transaction cost, is funded by increased equity contribution, $330 million instead of $275 million, since debt capacity is fully utilized; and
- We assume exit from the investment at the end of Year 6 at an exit multiple of 12x EBITDA.

V.2 Case 1: Foreign Holding Company Structure with Dividend Payments

Table 12: Output for Foreign Holding Company Structure with Dividends (and Dividend Tax)

($ in millions)	Year							
	1	2	3	4	5	6	7	8
Total Revenues	$100.0	$120.0	$144.0	$165.6	$190.4	$219.0	$240.9	$265.0
Growth %		*20.0%*	*20.0%*	*15.0%*	*15.0%*	*15.0%*	*10.0%*	*10.0%*
Gross Profit	$60.0	$72.0	$86.4	$91.1	$104.7	$120.5	$120.5	$132.5
Margin %	*60.0%*	*60.0%*	*60.0%*	*55.0%*	*55.0%*	*55.0%*	*50.0%*	*50.0%*
EBITDA	$40.0	$48.0	$57.6	$58.0	$66.7	$76.7	$72.3	$79.5
Margin %	*40.0%*	*40.0%*	*40.0%*	*35.0%*	*35.0%*	*35.0%*	*30.0%*	*30.0%*
EBITDA	$40.0	$48.0	$57.6	$58.0	$66.7	$76.7	$72.3	$79.5
Less: Cash Interest Expense	(12.6)	(11.4)	(9.9)	(7.9)	(5.6)	(2.9)	(0.6)	0.3
Less: Cash Taxes	(0.2)	(0.8)	(1.5)	(1.4)	(2.0)	(2.8)	(2.2)	(2.7)
Less: (Incr.)/Decr. in Working Capital	0.0	(3.0)	(3.6)	3.0	(2.8)	(3.2)	6.6	(1.8)
Less: Capital Expenditures	(12.0)	(14.4)	(17.3)	(19.9)	(22.9)	(26.3)	(28.9)	(31.8)
Free Cash Flow before Dividend Tax	15.2	18.4	25.3	31.8	33.4	41.4	47.1	43.4
Less: Dividend Tax	(2.3)	(2.8)	(3.8)	(4.8)	(5.0)	(6.2)	(7.1)	(6.5)
Free Cash Flow	**$12.9**	**$15.6**	**$21.5**	**$27.0**	**$28.4**	**$35.2**	**$40.1**	**$36.9**
Cumulative Free Cash Flow	12.9	28.5	50.0	77.1	105.4	140.6	180.7	217.6
Capitalization:								
Cash & Cash Equivalents	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$25.7	$62.6
Revolving Credit Facility	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Term Loan	142.1	126.5	105.0	77.9	49.6	14.4	0.0	0.0
Total Senior Debt	142.1	126.5	105.0	77.9	49.6	14.4	0.0	0.0
Seller Notes	144.7	161.0	179.2	199.5	222.1	247.2	275.1	306.2
Total Debt	286.8	287.5	284.2	277.5	271.6	261.5	275.1	306.2
Credit Statistics:								
Senior Debt / EBITDA	3.55x	2.63x	1.82x	1.34x	0.74x	0.19x	0.00x	0.00x
Total Debt / EBITDA	7.17x	5.99x	4.93x	4.79x	4.08x	3.41x	3.81x	3.85x
EBITDA / Cash Int. Exp.	3.17x	4.20x	5.81x	7.32x	11.91x	26.49x	112.83x	NA
(EBITDA - Capex) / Cash Int. Exp.	2.22x	2.94x	4.06x	4.81x	7.83x	17.41x	67.70x	NA

Table 13: Exit Valuation and Range of Values for IRR

Exit Valuation	**$ millions**
Exit Year	6
Exit Multiple	12.0x
Exit Year EBITDA	$76.7
Exit Valuation (Total Firm Value)	$919.8
Term Loan	14.4
Seller Notes	247.2
Less: Accumulated Cash	0.0
Net Debt	$261.5
Equity Value	$658.3

IRR Calculation		**Exit Year**				
	0.2	4	5	6	7	8
	11.0x	7.0%	10.9%	13.3%	10.3%	10.9%
Exit	11.5x	9.1%	12.5%	14.5%	11.3%	11.8%
Multiple	12.0x	11.0%	13.9%	**15.7%**	12.3%	12.6%
	12.5x	12.9%	15.3%	16.8%	13.2%	13.4%
	13.0x	14.7%	16.7%	17.8%	14.0%	14.1%

The term loan is fully repaid in Year 7. The financial investor earns an IRR of 15.7% based on 12.0x EBITDA exit valuation in Year 6.

V.3 Case 2: Foreign Holding Company Structure with Share Buyback

Table 14: Output for Foreign Holding Company Structure with Share Buyback

($ in millions)	Year							
	1	2	3	4	5	6	7	8
Total Revenues	$100.0	$120.0	$144.0	$165.6	$190.4	$219.0	$240.9	$265.0
Growth %		*20.0%*	*20.0%*	*15.0%*	*15.0%*	*15.0%*	*10.0%*	*10.0%*
Gross Profit	$60.0	$72.0	$86.4	$91.1	$104.7	$120.5	$120.5	$132.5
Margin %	*60.0%*	*60.0%*	*60.0%*	*55.0%*	*55.0%*	*55.0%*	*50.0%*	*50.0%*
EBITDA	$40.0	$48.0	$57.6	$58.0	$66.7	$76.7	$72.3	$79.5
Margin %	*40.0%*	*40.0%*	*40.0%*	*35.0%*	*35.0%*	*35.0%*	*30.0%*	*30.0%*
EBITDA	$40.0	$48.0	$57.6	$58.0	$66.7	$76.7	$72.3	$79.5
Less: Cash Interest Expense	(12.5)	(11.1)	(9.3)	(6.8)	(4.0)	(1.3)	0.2	0.7
Less: Cash Taxes	(0.2)	(0.8)	(1.6)	(1.5)	(2.2)	(3.0)	(2.2)	(2.8)
Less: (Incr.)/Decr. in Working Capital	0.0	(3.0)	(3.6)	3.0	(2.8)	(3.2)	6.6	(1.8)
Less: Capital Expenditures	(12.0)	(14.4)	(17.3)	(19.9)	(22.9)	(26.3)	(28.9)	(31.8)
Free Cash Flow before Dividend Tax	15.3	18.7	25.9	32.7	34.8	42.9	47.9	43.8
Less: Dividend Tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	**$15.3**	**$18.7**	**$25.9**	**$32.7**	**$34.8**	**$42.9**	**$47.9**	**$43.8**
Cumulative Free Cash Flow	15.3	34.0	59.8	92.6	127.4	170.3	218.2	262.0
Capitalization:								
Cash & Cash Equivalents	$0.0	$0.0	$0.0	$0.0	$0.0	$15.3	$63.2	$107.0
Revolving Credit Facility	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Term Loan	139.7	121.0	95.2	62.4	27.6	0.0	0.0	0.0
Total Senior Debt	139.7	121.0	95.2	62.4	27.6	0.0	0.0	0.0
Seller Notes	144.7	161.0	179.2	199.5	222.1	247.2	275.1	306.2
Total Debt	284.4	282.1	274.4	261.9	249.7	247.2	275.1	306.2
Credit Statistics:								
Senior Debt / EBITDA	3.49x	2.52x	1.65x	1.08x	0.41x	0.00x	0.00x	0.00x
Total Debt / EBITDA	7.11x	5.88x	4.76x	4.52x	3.75x	3.22x	3.81x	3.85x
EBITDA / Cash Int. Exp.	3.20x	4.32x	6.21x	8.47x	16.69x	60.94x	NA	NA
(EBITDA - Capex) / Cash Int. Exp.	2.24x	3.02x	4.35x	5.57x	10.97x	40.04x	NA	NA

Table 15: Exit Valuation and Range of Values for IRR

Exit Valuation	**$ millions**
Exit Year	6
Exit Multiple	12.0x
Exit Year EBITDA	$76.7
Exit Valuation (Total Firm Value)	$919.8
Term Loan	0.0
Seller Notes	247.2
Less: Accumulated Cash	(15.3)
Net Debt	$231.9
Equity Value	$688.0

IRR Calculation		Exit Year				
	0.2	4	5	6	7	8
	11.0x	8.1%	11.9%	14.2%	11.3%	11.9%
Exit	11.5x	10.1%	13.5%	15.4%	12.3%	12.7%
Multiple	12.0x	12.1%	14.9%	**16.5%**	13.2%	13.5%
	12.5x	13.9%	16.2%	17.6%	14.1%	14.2%
	13.0x	15.6%	17.5%	18.6%	14.9%	14.9%

The term loan is fully repaid in Year 6 instead of Year 7 as per the earlier scenario. The financial investor earns a higher IRR of 16.5% based on 12.0x EBITDA exit valuation.

V.4 Case 3: Asset Buyout Structure

Table 16: Output for Asset Buyout Structure (including Stamp Duty)

($ in millions)	Year 1	2	3	4	5	6	7	8
Total Revenues	$100.0	$120.0	$144.0	$165.6	$190.4	$219.0	$240.9	$265.0
Growth %		*20.0%*	*20.0%*	*15.0%*	*15.0%*	*15.0%*	*10.0%*	*10.0%*
Gross Profit	$60.0	$72.0	$86.4	$91.1	$104.7	$120.5	$120.5	$132.5
Margin %	*60.0%*	*60.0%*	*60.0%*	*55.0%*	*55.0%*	*55.0%*	*50.0%*	*50.0%*
EBITDA	$40.0	$48.0	$57.6	$58.0	$66.7	$76.7	$72.3	$79.5
Margin %	*40.0%*	*40.0%*	*40.0%*	*35.0%*	*35.0%*	*35.0%*	*30.0%*	*30.0%*
EBITDA	$40.0	$48.0	$57.6	$58.0	$66.7	$76.7	$72.3	$79.5
Less: Cash Interest Expense	(12.5)	(11.1)	(9.2)	(6.6)	(3.7)	(1.1)	0.3	0.8
Less: Cash Taxes	0.0	(0.0)	(0.8)	(0.7)	(1.4)	(2.2)	(1.5)	(2.8)
Less: (Incr.)/Decr. in Working Capital	0.0	(3.0)	(3.6)	3.0	(2.8)	(3.2)	6.6	(1.8)
Less: Capital Expenditures	(12.0)	(14.4)	(17.3)	(19.9)	(22.9)	(26.3)	(28.9)	(31.8)
Free Cash Flow before Dividend Tax	15.5	19.5	26.8	33.7	35.9	43.9	48.8	43.9
Less: Dividend Tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	**$15.5**	**$19.5**	**$26.8**	**$33.7**	**$35.9**	**$43.9**	**$48.8**	**$43.9**
Cumulative Free Cash Flow	15.5	35.0	61.8	95.5	131.3	175.2	224.0	267.8
Capitalization:								
Cash & Cash Equivalents	$0.0	$0.0	$0.0	$0.0	$0.0	$20.2	$69.0	$112.8
Revolving Credit Facility	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Term Loan	139.5	120.0	93.2	59.5	23.7	0.0	0.0	0.0
Total Senior Debt	139.5	120.0	93.2	59.5	23.7	0.0	0.0	0.0
Seller Notes	144.7	161.0	179.2	199.5	222.1	247.2	275.1	306.2
Total Debt	284.2	281.0	272.5	259.0	245.7	247.2	275.1	306.2
Credit Statistics:								
Senior Debt / EBITDA	3.49x	2.50x	1.62x	1.03x	0.35x	0.00x	0.00x	0.00x
Total Debt / EBITDA	7.11x	5.86x	4.73x	4.47x	3.69x	3.22x	3.81x	3.85x
EBITDA / Cash Int. Exp.	3.20x	4.34x	6.29x	8.74x	18.01x	72.05x	NA	NA
(EBITDA - Capex) / Cash Int. Exp.	2.24x	3.04x	4.41x	5.74x	11.84x	47.35x	NA	NA

Table 17: Exit Valuation and Range of Values for IRR

Exit Valuation	**$ millions**
Exit Year	6
Exit Multiple	12.0x
Exit Year EBITDA	$76.7
Exit Valuation (Total Firm Value)	$919.8
Term Loan	0.0
Seller Notes	247.2
Less: Accumulated Cash	(20.2)
Net Debt	$226.9
Equity Value	$692.9

IRR Calculation		Exit Year				
	0.1	4	5	6	7	8
	11.0x	3.5%	8.1%	11.0%	8.6%	9.5%
Exit	11.5x	5.4%	9.6%	12.1%	9.6%	10.3%
Multiple	12.0x	7.2%	10.9%	**13.2%**	10.4%	11.0%
	12.5x	9.0%	12.2%	14.2%	11.3%	11.7%
	13.0x	10.6%	13.5%	15.2%	12.1%	12.4%

The term loan is fully paid off in Year 6. The financial investor earns the lowest IRR among the 3 scenarios – 13.2% based on 12.0x EBITDA exit valuation.

VI. FINDINGS OF LEVERAGED BUYOUTS IN INDIA

VI.1 Industries of Focus

Two of the largest LBOs in India were those of business process outsourcing companies – Flextronics Software Systems (renamed Aricent after the LBO) and GECIS (renamed Genpact). Attractive industry sectors for LBOs in India would be outsourcing companies, service companies and high technology companies. Companies in these industry sectors are labor intensive and their costs are globally competitive due to a low-cost, highly educated English speaking workforce in India. The labor intensity of these businesses makes the target company scalable for achieving the high growth required to make the LBO successful. Further these companies typically earn their revenues from exports denominated in foreign currency, which mitigates foreign currency risk when the LBO is financed using foreign currency denominated debt raised from foreign banks. These companies also have low tax rates due to the tax incentives of operating from Special Economic Zones and Software Technology Parks.

Outsourcing, service and technology companies form an important part of India's exports, boast of a global customer base and have established a global reputation for service, quality and delivery.

VI.2 Growth Critical to the Success of the LBO

Standard & Poors expect the Indian economy to grow at a rate of 7.9 – 8.4% for the year 2007-2008. One of the key drivers of return in a LBO in India is growth. India is in a growth stage and the markets are relatively young compared to those in developed countries. Indian companies face large capital requirements and despite the ample availability of capital in the international markets and in India for portfolio investments, there is a shortage of capital for funding operations and growth.

Indian companies that are targets of buyouts are experiencing significant year-on-year growth, generally 15-20% every year and sometimes as high as 40-60%. A joint report published by NASSCOM and McKinsey in December 2005 projected a 42.1% compound annual growth rate of the overall Indian offshore business process outsourcing industry for the period 2003-2006. The NASSCOM-McKinsey report estimates that the offshore business process outsourcing industry will grow at a 37.0% compound annual growth rate, from $11.4 billion in fiscal 2005 to $55.0 billion in fiscal 2010. The NASSCOM-McKinsey report estimates that India-based players accounted for 46% of offshore business process outsourcing revenue in fiscal 2005 and India will retain its dominant position as the most favored offshore business process outsourcing destination for the foreseeable future. It forecasts that the Indian offshore business process outsourcing market will grow from $5.2 billion in revenue in fiscal 2005 to $25.0 billion in fiscal 2010, representing a compound annual growth rate of 36.9%. Additionally, it identifies retail banking, insurance, travel and hospitality and automobile manufacturing as the industries with the greatest potential for offshore outsourcing.

Warburg Pincus purchased 85% of WNS Global Services, a business process outsourcing company, from British Airways for $40 million in 2002. WNS Global Services offers a wide range of offshore support services to its global customers, particularly within the travel, insurance, financial, enterprise and knowledge industries. WNS Global Services completed its initial public offering on the NYSE in July 2006. WNS Global Services has a market capitalization (as of March 2007) of $1.19 billion. WNS Global Services was a young and growing company (instead of a mature company with steady cash flows as required for a typical LBO) when it was acquired by Warburg Pincus. Given the size of the transaction, it was all equity financed as it may not have been possible to obtain debt for a transaction of that size.

The following table elaborates on the growth history / prospects of some of the companies that are buyouts / leveraged buyouts in India.

Table 18: Growth History / Prospects of Target Companies

Company	***Growth History / Prospects***
Flextronics Software Systems	Revenues for the year ended March 31, 2005 amounted to $117.5 million as per reported US GAAP financial statements. Based on an October 2006 interview, the company disclosed annual revenues to be ‘a bit more than $300 million’. The company is targeting to achieve revenues of $1 billion by 2011-12.
GE Capital International Services	Annual revenues of $404 million and $493 million in 2004 and 2005 respectively. The Company has set a stiff target of achieving an annual revenue of $1 billion by December 2008. Of this, the additional revenue growth of $500 million includes $350 million through organic growth and $150 million through acquisitions.
WNS Global Services	Reported revenues of $104 million, $162 million and $203 million for 2004, 2005 and 2006 respectively. Between fiscal 2003 and fiscal 2006, revenue grew at a compound annual growth rate of 54.9%.
RFCL (businesses of Ranbaxy)	Expected to double revenues in the financial year 2006-2007.
Infomedia India	Expected to show a very significant increase in revenue and profits in financial year 2007, and is expected to double its profits in that year from that in the previous year.
VA Tech WABAG India	Revenues at VA Tech WABAG are expected to grow at a rate of 30% over financial year 2005-06.
ACE Refractories (refractories business of ACC)	Ace Refractories is expecting to grow revenues by more than 20%, with exports growing by about 40%.

The high growth characteristics of the target company entails greater execution risk for the management of the target company and the financial investor. Most of the equity returns are generated from growth by scaling and ramping up the operations of the portfolio company through hiring and training employees, expanding capacity and adding additional customer contracts. This sort of rapid scaling up of operations requires high quality management talent, robust internal processes and a large pool of skilled human resources. Executing the growth business plan and delivering the growth is key to return on the investment.

The following table from the financial model illustrates the dramatic decline in profitability as a result of slower than planned growth of the target company.

Table 19: Output for Foreign Holding Company Structure with Share Buyback (Slow Growth Case)

($ in millions)	Year 1	2	3	4	5	6	7	8
Total Revenues	$100.0	$115.0	$128.8	$141.7	$155.8	$168.3	$181.8	$192.7
Growth %		*15.0%*	*12.0%*	*10.0%*	*10.0%*	*8.0%*	*8.0%*	*6.0%*
Gross Profit	$60.0	$69.0	$77.3	$77.9	$85.7	$92.6	$90.9	$96.3
Margin %	*60.0%*	*60.0%*	*60.0%*	*55.0%*	*55.0%*	*55.0%*	*50.0%*	*50.0%*
EBITDA	$40.0	$46.0	$51.5	$49.6	$54.5	$58.9	$54.5	$57.8
Margin %	*40.0%*	*40.0%*	*40.0%*	*35.0%*	*35.0%*	*35.0%*	*30.0%*	*30.0%*
EBITDA	$40.0	$46.0	$51.5	$49.6	$54.5	$58.9	$54.5	$57.8
Less: Cash Interest Expense	(12.5)	(11.1)	(9.4)	(7.3)	(4.9)	(2.3)	(0.4)	0.3
Less: Cash Taxes	(0.2)	(0.6)	(1.1)	(0.8)	(1.2)	(1.5)	(0.9)	(1.2)
Less: (Incr.)/Decr. in Working Capital	0.0	(2.3)	(2.1)	3.4	(1.6)	(1.4)	5.3	(0.8)
Less: Capital Expenditures	(12.0)	(13.8)	(15.5)	(17.0)	(18.7)	(20.2)	(21.8)	(23.1)
Free Cash Flow before Dividend Tax	15.3	18.2	23.5	27.9	28.1	33.5	36.8	33.0
Less: Dividend Tax	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Free Cash Flow	**$15.3**	**$18.2**	**$23.5**	**$27.9**	**$28.1**	**$33.5**	**$36.8**	**$33.0**
Cumulative Free Cash Flow	15.3	33.5	57.0	84.9	113.0	146.5	183.2	216.2
Capitalization:								
Cash & Cash Equivalents	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$28.2	$61.2
Revolving Credit Facility	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Term Loan	139.7	121.5	98.0	70.1	42.0	8.5	0.0	0.0
Total Senior Debt	139.7	121.5	98.0	70.1	42.0	8.5	0.0	0.0
Seller Notes	144.7	161.0	179.2	199.5	222.1	247.2	275.1	306.2
Total Debt	284.4	282.6	277.3	269.7	264.1	255.7	275.1	306.2
Credit Statistics:								
Senior Debt / EBITDA	3.49x	2.64x	1.90x	1.41x	0.77x	0.14x	0.00x	0.00x
Total Debt / EBITDA	7.11x	6.14x	5.38x	5.44x	4.84x	4.34x	5.04x	5.30x
EBITDA / Cash Int. Exp.	3.20x	4.13x	5.47x	6.80x	11.05x	25.41x	144.78x	NA
(EBITDA - Capex) / Cash Int. Exp.	2.24x	2.89x	3.83x	4.47x	7.26x	16.70x	86.87x	NA

Table 20: Exit Valuation and Range of Values for IRR (Slow Growth Case)

Exit Valuation	**$ millions**
Exit Year	6
Exit Multiple	12.0x
Exit Year EBITDA	$58.9
Exit Valuation (Total Firm Value)	$706.9
Term Loan	8.5
Seller Notes	247.2
Less: Accumulated Cash	0.0
Net Debt	$255.7
Equity Value	$451.2

IRR Calculation		Exit Year				
	0.1	4	5	6	7	8
	11.0x	0.1%	4.1%	6.1%	3.6%	4.5%
Exit	11.5x	2.3%	5.7%	7.4%	4.7%	5.4%
Multiple	12.0x	4.3%	7.3%	**8.6%**	5.8%	6.3%
	12.5x	6.2%	8.7%	9.8%	6.8%	7.1%
	13.0x	8.1%	10.1%	10.8%	7.7%	7.9%

Note that the growth assumptions in this case are far higher than those of LBOs in the US and in Europe.

VI.3 Growth Puts Structural Limitations on Leverage

The internal operating cash flows generated by a target company which is growing in excess of 15-20% every year would be required to finance the growth through investment in capital expenditure and working capital. As a result, a financial investor may not be able to gear a capital-intensive target company to the same level as that in international markets. The hypothetical model in section V assume capital expenditure at 12% of revenues, which may be significantly understating reality for industrial companies.

VI.4 Indian LBOs Favor The Use of Pay-In-Kind Securities with Bullet Repayment

Since the debt servicing for a typical Indian LBO is through dividend payments / proceeds of share buyback and the Foreign Holding Company receives lump sum sale proceeds on divestiture of the portfolio company, the debt that most is most friendly to the LBO is a non-amortizing loan with Pay-In-Kind ("PIK") interest payments and a 5-8 year bullet repayment at maturity. The debt is not required to be serviced through cash payments during the investment period, thus saving dividend tax and the requirement to remit proceeds through share buybacks. Further, the payment on divestiture of the operating company may be used to make the bullet repayment of the loan. This is very similar to the Seller Note used as financing in the LBO of Flextronics Software Systems by KKR. However, providing collateral to the lenders remains an issue that may be addressed through the pricing of such a security.

VI.5 Ideal LBO Targets in India

Diversified conglomerates operate in number of non-core business areas in India that they are constantly looking to divest. These businesses make ideal LBO targets in India since they have established operations, business processes and professional management in place. There is a large interest among private equity players to buy non-core businesses from conglomerates.

Table 21: List of Buyouts Carved out of Conglomerates

Company	*Financial investor*	*Seller*
Flextronics Software Systems	KKR	Flextronics International
GE Capital International Services	General Atlantic Partners, Oak Hill	General Electric
Nitrex Chemicals	Actis Capital	ICI India
WNS Global Services	Warburg Pincus	British Airways
RFCL	ICICI Venture	Ranbaxy
Infomedia India	ICICI Venture	Tata Group
VA Tech WABAG India	ICICI Venture	VA Tech
ACE Refractories	ICICI Venture	ACC

Other potential targets for LBOs in India include mid-cap second generation family run businesses looking at bringing in professional management (Phoenix Lamps, Nilgiris Dairy Farm, Nirula's), distress sale of companies and privatization by the Government (Punjab Tractors).

VI.6 Debt Raised in India

Indian banks participate in providing working capital loans to companies that are buyout targets. Further, Indian banks also tend to participate in the syndicate for bank debt of LBOs.

Table 22: Details of Participation

Company	*Debt*	*Details of Participation*
GE Capital International Services	\$215 million	ICICI Bank was one of 6 lead arrangers of the loan.
		ICICI Bank participated in the syndicate by holding 8.6% of the loan.
GE Capital International Services	\$250 million	ICICI Bank was one of 6 co-arrangers of the loan.
		ICICI Bank participated in the syndicate by holding 7.4% of the loan.
AE Rotor Holding BV (subsidiary of Suzlon Energy)	€450 million[1]	ICICI Bank and State Bank of India were among the lenders holding 33.33% and 25% of the debt respectively.
UB Group	INR 13.1 billion	ICICI Bank – Mandated arranger

Source: Bloomberg Loan Syndication Data
1 Raised for the LBO of Hansen Transmissions, Netherlands

The list above does not include participation by Indian branches of foreign banks such as Citigroup, HSBC and Standard Chartered Bank.

VI.7 Exit Strategies for Private Equity Investments

In the past, there have been 2 successful / partial exits from the list in Table 4. WNS Global Services was taken public by Warburg Pincus on the New York Stock Exchange, while Actis has sold off the trading division of Nitrex Chemicals to a strategic player – Danish firm East Asiatic Co AS. Exit opportunities for LBOs in India are similar to those available to existing private equity players who make equity / minority investments in companies in India. These include listing on the domestic stock exchanges, listing on a US stock exchange or a strategic sale.

The following table lists some recent / notable private equity exist in India.

Table 23: Recent Private Equity Exits in India

Company	*Seller (Stake)*	*Exit*	*Year*
Suzlon Energy	Citicorp, ChrysCapital	Domestic IPO	2005
Punj Lloyd	Merlion, Stanchart, Temasek	Domestic IPO	2005
HT Media	Henderson, CIFC	Domestic IPO	2005
YES Bank	CVC International, ChrysCapital	Domestic IPO	2005
Shopper's Stop	ICICI Ventures, IL&FS Investment Managers	Domestic IPO	2005
IVRCL	ChrysCapital	Domestic IPO	2005
PVR Cinemas	ICICI Venture	Domestic IPO	2005
Bharti Tele-Ventures	Warburg Pincus	Sale on domestic stock exchange	2004 / 2005
Gujarat Ambuja	Warburg Pincus	Sale on domestic stock exchange	2005
WNS Global Services	Warburg Pincus	NYSE IPO	2006
UTI Bank	Actis	Financial buyer – HSBC Global Investment Fund	2004
Baazee.com	ChrysCapital	Strategic buyer – eBay	2004
Mphasis BFL Software	Barings Private Equity Partners	Strategic buyer – EDS	2006
BPL Communications	Actis, AIG	Strategic buyer – Essar	2005
Daksh e-Services	Actis, General Atlantic Partners	Strategic buyer – IBM	2004
JobsAhead.com	ChrysCapital	Strategic buyer – Monster	2004
Matrix Laboratories	TPG Newbridge	Strategic buyer – Mylan Laboratories	2006
i-flex	CVC International	Strategic buyer – Oracle	2005
Spectramind e-Services	ChrysCapital	Strategic buyer – Wipro	2002

VI.8 The Advent of Global Private Equity Players in India

India has witnessed a significant inflow of foreign capital including that from global private equity players that are setting up shop in India. This trend is expected to continue and fuel the growth of buyout and leveraged buyout activity in India.

European buyouts veteran Henderson Private Capital, which manages funds of $1.5 billion, is investing in India out of its $210 million Henderson Asia Pacific Equity Partners I Fund. It was set to create a $300-million fund for Asia, of which 40% will be invested in India.

The Singapore government, the second largest foreign private equity investor in India has shifted focus from early-stage investments to growth and buyout capital. Its direct investments company Temasek Holdings has teamed up with Standard Chartered Private Equity to set up the $100 million Merlion India Fund.

Global private equity firm The Carlyle Group announced in mid-2005 that it had established a buyout team in India based out of Mumbai. The Carlyle India buyout team is part of Carlyle's Asia buyout group, which manages a $750 million Asia buyout fund. Carlyle also has two dedicated Asia growth capital funds totaling $323 million.

The Blackstone Group recently elevated India to one of its key strategic hubs in Asia. Blackstone hired several consulting firms, including McKinsey & Co., and looked at investing in various emerging markets. It chose India as the place to set up its next in-country office and intends to invest $1 billion in local companies.

London-based Actis is among the most experienced investors in India. Actis' Fund II is a $1.6 billion fund of which $325 million has been earmarked for investments in India. Actis has been active in India since 1998 in private equity and since 1996 as a venture capital investor. Another experience global player, Warburg Pincus has been is active in India since 1995 and has made several successful private equity investments and profitable exits in India such as the sale of a 19% stake in Bharti Tele-Ventures for $1.6 billion (cost $292 million). General Atlantic Partners has an office in India since 2001 and has executed several successful private equity transactions including the sale of Daksh e-Services and the initial public offering of Patni Computers.

With the presence of most major BO / LBO shops in India, a greater number of buyouts / leveraged buyouts are expected going forward.

Appendix I

SECTOR CAPS AND ENTRY ROUTES (AS ON 26 FEBRUARY 2006)

Source: Investment Commission of India – www.investmentcommission.in

A. Infrastructure Sectors	Ownership Limit	Entry Route	Remarks
Power	100%	Automatic	Includes generation (except nuclear power where FDI is prohibited), transmission and distribution of power
Telecom	100%	Automatic	
Basic, cellular and value-added services			
ISP with gateways			
ISP without gateways			
Email, Voice mail			
Radio Paging			
End-to-End Bandwidth			
Infrastructure Providers providing Dark Fibre			
Telecom Manufacturing			
Roads	100%	Automatic	Includes construction and maintenance of roads, highways, bridges and tunnels
Ports	100%	Automatic	Applies to construction and maintenance of ports
Civil Aviation			
Airports	100%	FIPB beyond 74%	100% FDI under automatic route is permissible for greenfield airports.
Domestic Airlines	49%	Automatic	Subject to no direct or indirect equity participation by foreign airlines. FDI up to 100% allowed for NRIs
Petroleum & Natural Gas			
Petroleum refining	100%	Automatic	
Petroleum product pipelines	100%	Automatic	
Petroleum product marketing	100%	Automatic	Subject to divestment of 26% equity in favour of the Indian partner / public within 5 years.
Petroleum refining-PSUs	26%	FIPB	
Others			
Mass Rapid Transport System	100%	Automatic	Includes associated real estate development in all metropolitan cities
EOU/SEZ/Industrial park construction	100%	Automatic	Subject to SEZ Act 2005 and Foreign Trade Policy.
Satellite establishment and operation	74%	FIPB	

B. Services Sectors	Ownership Limit	Entry Route	Remarks
Banking			
Indian Private Banks	74%	Automatic	Foreign banks can take an equity stake of more than 5% (up to 74%) only in the private sector banks which have been identified by the RBI for restructuring
PSU Banks	20%		Subject to compliance with RBI guidelines
NBFCs	100%	Automatic	Includes 19 specified activities; Subject to minimum capitalisation norms and compliance with RBI guidelines
Insurance	26%	Automatic	Includes both Life and Non-Life Insurance; Subject to licence from Insurance Regulatory & Development Authority
Real estate and construction	100%	Automatic	Subject to minimum land area of 10 hectare for serviced housing plot and built-up area of 50,000 sq. mts. for construction development projects. Also minimum capitalisation and completion norms
Townships			
Housing			
Construction – Development Projects			
Build-up Infrastructure			
Trading			
Retail Trade	51%	FIPB	Only for single brand products
Trading (Export House, Super Trading House, Star Trading House)	51%	Automatic	
Trading (Export, Cash and Carry Wholesale)	100%	FIPB	
Tourism			
Hotels, restaurants, beach resorts	100%	Automatic	Includes facilities for providing accommodation and food services
Tour and travel agencies	100%	Automatic	
Broadcasting			
TV software production	100%		Subject to maximum foreign equity up to 49% including FDI/NRI/FII
Hardware facilities - (Uplinking, HUB, etc.)	49%		Subject to maximum foreign equity up to 49% including FDI/NRI/FII; FDI in news and current affairs channels which uplink from India is capped at 26%
Cable network	49%		Subject to maximum foreign equity up to 49% including FDI/NRI/FII
DTH	20%		Subject to maximum foreign equity upto 49% including FDI/NRI/FII. FDI not to exceed 20%
Terrestrial Broadcast FM	20%		Subject to licensee being a company registered in India under the Companies Act, 1956
Terrestrial TV Broadcast	Not Permitted		
Print Media			
Scientific/Technical journals	100%		
Other non-news/non-current affairs/specialty publications	74%		
Newspapers, Periodicals dealing with news and current affairs	26%		
Other Services			
Advertising and Film	100%	Automatic	Includes all film related activities

Courier services	100%	FIPB	Includes all postal services except the distribution of letters
Lottery, Betting and Gambling	Not Permitted	—	
Defence and Strategic Industries	26%	FIPB	Subject to security and licensing requirement; to be sold primarily to the Ministry of Defence
R&D activities	100%	Automatic	

C. Manufacturing Sectors	**Ownership Limit**	**Entry Route**	**Remarks**
Metals	100%	Automatic	Includes manufacture of Steel, Aluminium etc.
Textiles and Garments	100%	Automatic	
Electronics Hardware	100%	Automatic	
Chemicals and Plastics	100%	Automatic	Includes plastics
Automobiles	100%	Automatic	Includes Two -wheelers, Cars and Commercial Vehicles
Auto Components	100%	Automatic	
Gems and Jewellery	100%	Automatic	
Food and Agro Products			
Food Processing	100%	Automatic	
Agriculture (including contract farming)	Not Permitted	-	
Plantations (except Tea)	Not Permitted	-	
Other Manufacturing			
Items reserved for Small Scale	24%	Automatic	100% FDI permitted through FIPB route subject to undertaking of export obligation of 50%

D. Resource Based Sectors	**Ownership Limit**	**Entry Route**	**Remarks**
Coal and Lignite			
Coal Processing	100%	Automatic up to 50%	
Captive Coal mining	100%	Automatic	Subject to provision of Coal Mines (Nationalisation) Act 1973.
Other Mining and Quarrying			
Mineral Ores	100%	Automatic	Including Gold, Silver and other mineral ores
Diamonds and precious stones	100%	Automatic	
Atomic Minerals	74%	FIPB	Includes only mining, mineral separation and subsequent value addition
Oil and Natural Gas Exploration	100%	Automatic	

E. Knowledge Economy Sectors	**Ownership Limit**	**Entry Route**	**Remarks**
Pharma and Biotech	100%	Automatic	FIPB route is needed if industrial licence is required or involves recombinant DNA technology, cell/tissue formulations
Healthcare	100%	Automatic	
Information Technology	100%	Automatic	

Appendix II

COMPANIES ACT, 1956 – SECTION 77

Restrictions on purchase by company, or loans by company for purchase, of its own or its holding company's shares

(1) No company limited by shares, and no company limited by guarantee and having a share capital, shall have power to buy its own shares, unless the consequent reduction of capital is effected and sanctioned in pursuance of sections 100 to 104 or of section 402.

(2) No public company, and no private company which is a subsidiary of a public company, shall give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of or for any shares in the company or in its holding company:

Provided that nothing in this sub-section shall be taken to prohibit-

(a) the lending of money by a banking company in the ordinary course of its business; or

(b) the provision by a company, in accordance with any scheme for the time being in force, of money for the purchase of, or subscription for, fully paid shares in the company or its holding company, being a purchase or subscription by trustees of or for shares to be held by or for the benefit of employees of the company, including any director holding a salaried office or employment in the company; or

(c) the making by a company of loans, within the limit laid down in sub-section (3) to persons (other than directors [1][***] or managers) bona fide in the employment of the company with a view to enabling those persons to purchase or subscribe for fully paid shares in the company or its holding company to be held by themselves by way of beneficial ownership.

(3) No loan made to any person in pursuance of clause (c) of the foregoing shall exceed in amount his salary or wages at that time for a period of six months.

(4) If a company acts in contravention of sub-sections (1) to (3), the company, and every officer of the company who is in default, shall be punishable with fine which may extend to [2][ten thousand rupees].

(5) Nothing in this section shall affect the right of a company to redeem any shares issued under section 80 or under any corresponding provision in any previous companies law.

1. The words "managing agent, secretaries and treasurers" omitted by Act 53 of 2000, sec. 33 (w.e.f. 13-12-2000).

2. Subs by Act 53 of 2000, sec. 33, for "one thousand rupees" (w.e.f. 13-12-2000).

Appendix III

GOVERNMENT OF INDIA

MINISTRY OF INDUSTRY

DEPARTMENT OF INDUSTRIAL POLICY AND PROMOTION

***

PRESS NOTE NO. 9 (1999 SERIES)

SUBJECT: Policy relating to the standard conditions applicable to foreign owned Indian holding companies requiring prior and specific approval of FIPB/Government for downstream investment in Annexure III activities, which qualify for Automatic Approval.

1. The Government have reviewed the existing policy relating to the standard conditions applicable to foreign owned Indian holding companies requiring prior and specific approval of FIPB/Government for downstream investment. On careful consideration of the matter and with a view to further simplifying the investment procedures for downstream investment, it has been decided to permit foreign owned Indian holding companies to make downstream investment in Annexure III activities, which qualify for Automatic Approval subject to the following conditions:-

    a. downstream investments may be made within foreign equity levels permitted for different activities under the automatic route;

    b. proposed/existing activities for the joint venture company being fully confined to Annexure III activities;

    c. increase in equity level resulting out of expansion of equity base of the existing/fresh equity of the new joint venture company;

    d. the downstream investment involving setting up of an EOU/STP/EHTP project or items involving compulsory licensing; SSI reserved items; acquisition of existing stake in an Indian company by way of transfer/ as also buyback shall not be eligible for automatic approval and shall require prior approval of FIPB/Government;

    e. the holding company to notify SIA of its downstream investment within 30 days of such investment even if shares have not been allotted alongwith the modality of investment in new/existing ventures (with/without expansion programme);

    f. proposals for downstream investment by way of induction of foreign equity in an existing Indian Company to be duly supported by a resolution of the Board of Directors supporting the said induction as also a shareholders= Agreement and consent letter of the Foreign Collaborator;

    g. issue/transfer/pricing/valuation of shares shall be in accordance with SEBI/RBI guidelines;

    h. foreign owned holding companies would have to bring in requisite funds from abroad and not leverage funds from domestic market for such investments. This would, however, not preclude downstream operating companies to raise debt in the domestic market.

2. The above procedure will form part of the FIPB Guidelines and paragraph 11 (a) of the Guidelines for the consideration of Foreign Direct Investment (FDI) proposals by the Foreign Investment Promotion Board (FIPB)@ notified vide Press Note NO. 3(1997 Series) shall stand modified accordingly in respect of down stream investment by foreign owned Indian holding companies.

3. All investors and entrepreneurs may please take note of the aforesaid revision in the policy.

Sd/-

(ASHOK KUMAR)

JOINT SECRETARY

F.No. 7(13)/99-IP

New Delhi, the 12th April, 1999

Forwarded to the Press Information Bureau for giving wide publicity to the contents of the above Press Note.

Press information Officer,
Press Information Bureau,
New Delhi.

Appendix IV

EXTRACTS OF THE MASTER CIRCULAR

Date: Aug 28, 1998
Dir.BC.90/13.07.05/98
28 August 1998

<u>Advances against Shares, Units, Debentures and Public Sector Undertaking (PSU) Bonds</u>

7. Advances to other borrowers against shares/debentures/bonds

   The question of granting advances against primary security of shares and debentures including promoters shares to industrial, corporate or other borrowers should not normally arise. However, such securities can be accepted as collateral for secured loans granted as working capital or for other productive purposes from borrowers other than NBFCs. In such cases banks may increasingly accept shares in dematerialised form. Banks may accept shares of promoters only in dematerialised form wherever demat facility is available.

   In the course of setting up of new projects or expansion of existing business or for the purpose of raising additional working capital required by units other than NBFCs, there may be situations where such borrowers are not able to find the required funds towards margin, pending mobilisation of long term resources. In such cases, there would be no objection to the banks obtaining collateral security of shares and debentures by way of margin. Such arrangements would be of a temporary nature and may not be continued beyond a period of one year. Banks have to satisfy themselves regarding the capacity of the borrower to raise the required funds and to repay the advance within the stipulated period.

8. Bank Loans for Financing Promoters contribution

   The promoters' contribution towards the equity capital of a company should come from their own resources and the bank should not normally grant advances to take up shares of other companies. However, banks are permitted to extend loans to corporates against the security of shares (as far as possible in dematerialised form) held by them to meet the promoters' contribution to the equity of new companies in anticipation of raising resources subject to the following terms and conditions, in addition to the general guidelines given in the Annexure:

   a. The margin and period of repayment of the loans may be determined by the banks.

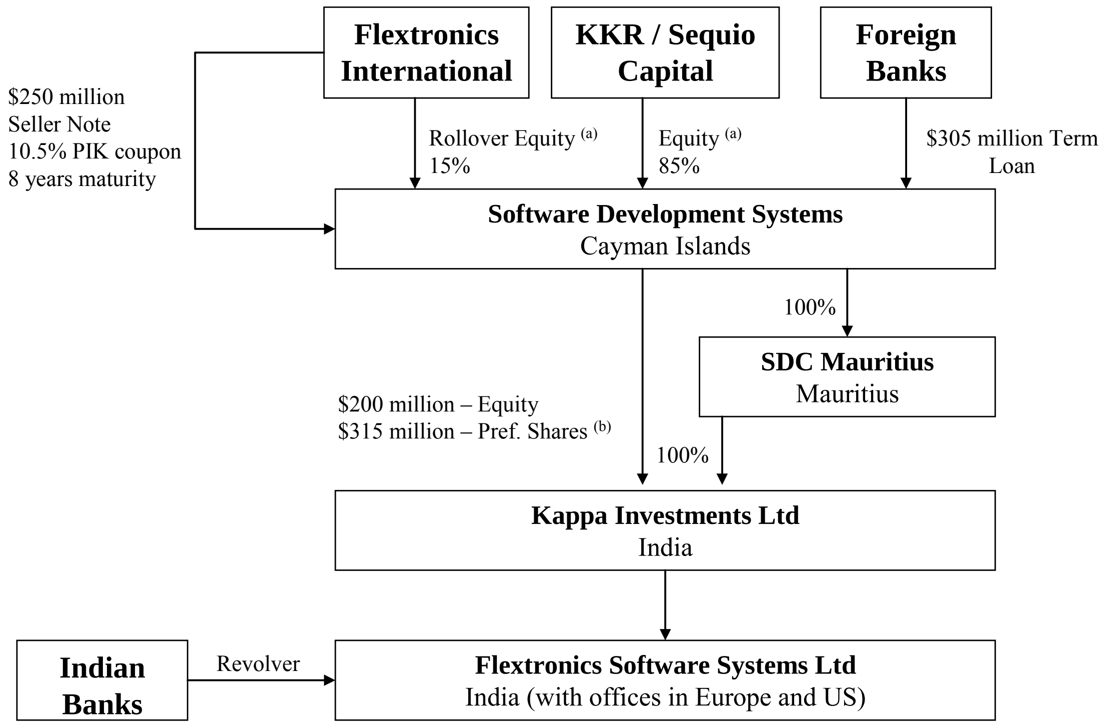
   b. Loans sanctioned to corporates for meeting promoters' contribution should be treated as banks' investments in shares and would thus come under the ceiling of 5 per cent of the incremental deposits of the previous year prescribed for investments in shares/convertible debentures of PSUs, corporate bodies, units of mutual fund schemes and in equity of dedicated venture capital funds meant for information technology.

   c. With the approval of the Boards of Directors, the banks should formulate internal guidelines with appropriate safeguards for this purpose.

   d. Under the refinance scheme of Export-Import Bank of India, the banks may sanction term loans on merits to eligible Indian promoters for acquisition of equity in overseas joint ventures/wholly owned subsidiaries, provided the term loans have been approved by the EXIM Bank for refinance.

Appendix V

Foreign Holding Company Structure of Flextronics Software Systems



(a) Total Equity = $345 million + Transaction fees and expenses not exceeding $37 million
(b) Redeemable optionally convertible preference shares with a non-cumulative coupon rate of 0.1 per cent per annum

Sources:
Flextronics International Ltd Form 8-K filed on April 13, 2006
"KKR of US to invest $515 m in Indian IT sector" – Business Line – Jul 14, 2006

Appendix VI

MINORITY PRIVATE EQUITY TRANSACTIONS IN INDIA

Announce Date	Target Name	Acquirer Name	Announced Total Value (mil.)	Deal Status	Description
Jul 2006	Allsec Technologies	The Carlyle Group	16.86	Pending	Stake of 25%
Feb 2006	Bajaj Auto Finance	ChrysCapital	10.48	Complete	Sale of 5% through private placement
Apr 2006	Dalmia Cement (Bharat)	Actis Capital LLP	25.00	Pending	Negotiations for an 11% stake
Jun 2006	Diamond Cables	Clearwater Capital Partners	5.17	Complete	Private placement of 14.9%
Feb 2006	DTDC Courier & Cargo	Reliance Capital Limited	15.83	Complete	Purchase of 44%
Jul 2006	Emcure Pharmaceuticals	Blackstone Group	50.00	Complete	
Aug 2006	EMI Transmission	Reliance Power India Fund	11.00	Complete	23% stake
Aug 2006	Endurance Group	Standard Chartered PLC	33.00	Complete	
May 2006	Greenply Industries	Aeneas Portfolio Co LP	5.89	Pending	13.81% stake
Mar 2006	Hexaware Technologies	General Atlantic LLC	67.57	Pending	Preferential allotment of 14.99% equity stake
Jul 2006	Imimobile	Pequot Capital Management	10.00	Complete	
Jun 2006	Indiabulls Buildcon	FIM Ltd	3.28	Complete	36% stake
Jan 2006	Indiabulls Housing Finance	Farallon Capital	25.43	Pending	
Jan 2006	Intas Pharmaceuticals	ChrysCapital	10.77	Pending	12.5% stake purchased from ICICI Ventures
Apr 2006	Jai Parabolic Springs	Clear Water Capital Partners	3.46	Complete	Private placement
Mar 2006	Jindal Poly Films	Saif Partners Ltd	12.54	Complete	6.66% stake through an off-market transaction
Nov 2005	JMT Auto	ChrysCapital	0.02	Complete	20% open offer along with Bach Ltd
Mar 2006	Kopran	Clearwater Capital Partners	5.80	Complete	14.95% stake new equity issue
Apr 2006	Maxwell Industries	Reliance Capital Partners	6.44	Pending	14.55% stake
Nov 2005	Merittrac Services	Hav2 Mauritius Ltd	3.61	Complete	
May 2006	Metropolis Health Services	ICICI Bank Ltd	7.80	Complete	
Aug 2006	Microland	Multiple Acquirers	11.00	Complete	Funding from Cargill Ventures, Intel Capital, Trident Capital and JAFCO
Nov 2005	Naturol Bioenergy	APIDC Venture Capital Ltd	3.92	Complete	Venture capital deal for setting up a plant in AP

Announce Date	Target Name	Acquirer Name	Announced Total Value (mil.)	Deal Status	Description
Oct 2006	OCM India	Wl Ross & Co	37.00	Complete	The acquisition, billed as the first 100 per cent buyout by a global turnaround fund, was carried out by ARCIL, the company said.
Mar 2006	People Interactive Pvt Ltd	Westbridge Capital Partners	8.00	Complete	
Oct 2005	Prasad Corp Pvt Ltd	IL&FS Investment Managers	6.66	Complete	
Mar 2006	Redington India Ltd	ChrysCapital	15.09	Complete	11% stake
Dec 2005	Sandhar Locking Devices Ltd	Actis Capital LLP	23.00	Complete	Actis has invested $23 million
Nov 2005	Semantic Space Pvt Ltd	UTI Ventures Ltd	2.00	Complete	Venture capital investment
Feb 2006	Shriram Holdings Madras	Newbridge Capital LLC	108.00	Complete	49% purchase
Nov 2005	Sify Ltd-Sponsored ADR	Infinity Capital Ventures LP	62.60	Pending	31.61% sale by Satyam
Oct 2005	Spentex Industries	Citigroup Inc	14.19	Complete	
Dec 2005	Spentex Industries	Citigroup Inc	9.21	Pending	
Sep 2006	Textrade International	Reliance Capital Limited	10.00	Complete	26% acquisition
Jan 2006	Unichem Laboratories Ltd	New Vernon Private Equity	12.69	Complete	5% stake

Source: Bloomberg

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