Insights: Publications

Raising Cross-Border Debt - The Indian and US Experience

3-Part Series: COVID-19's Impact on US & Indian M&A Markets

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India

Over the last decade, alternatives to traditional bank lending have emerged to service the debt requirements of Indian corporates. With Indian banks and non-bank companies facing stress (due to rising bad debt levels), Indian corporations are increasingly looking to tap into foreign debt sources. The development of offshore loan and debt markets can also be attributed to the operation of the Insolvency and Bankruptcy Code, 2016, which accords significant powers to creditors of debt-ridden Indian companies to restructure and resolve bad debts.

Direct Offshore Funding

The Reserve Bank of India (RBI) regulates cross-border debt raises by Indian entities. In cases where debt securities issued are to be listed on Indian stock exchanges, regulations of the Securities Exchange Board of India (SEBI) will also become applicable. Broadly speaking, Indian entities can access foreign debt through the 'external commercial borrowing' route, or by issuing debt capital to 'foreign portfolio investors'.

External Commercial Borrowings – External Commercial Borrowings (ECBs) are commercial loans raised by eligible Indian borrowers from recognized overseas lenders, subject to regulatory considerations in the nature of end-use restrictions of borrowed funds, all-in borrowing costs, etc. The ECB framework divides ECBs into two categories: foreign currency denominated ECBs and Indian Rupee denominated ECBs (which also includes Masala Bonds).

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ECBs can be availed by Indian entities permitted to raise 'foreign direct investments' (and certain other identified entities specifically permitted to raise ECBs). The RBI regulates ECBs by placing limitations on borrowing sizes, borrowing costs, use of proceeds (excluding real estate activities and investments in capital markets) and collateral packages; debt raises not structured within these parameters may be subject to prior RBI approvals. Further, applicable regulations also require ECB raises to be reported to the RBI.

The Indian government sought to spur cross-border ECB financings by bringing out a series of amendments in 2019 that relaxed various regulatory parameters (including permitting refinancing onshore debt through ECBs and direct assignment of stressed Indian Rupee loans to offshore lenders).

Masala Bonds – Similar to Kangaroo bonds (Australia) and Samurai bonds (Japan), 'Masala Bonds' are Indian Rupee denominated bonds, eloquently titled to signify its association with its home country. 'Masala Bonds' are governed by the same legal framework that govern ECBs, vis-à-vis kinds of entities eligible to raise finance, use of proceeds, restrictions etc., and are required to be structured as 'plain vanilla' bonds. Given the currency denominating the bonds, forex risks associated with borrowings are passed onto the offshore investor; consequently, volatile exchange rates and changes in domestic interest rates may affect the marketability of the bonds.

Debt issuances to foreign portfolio investors – Foreign entities specifically registered with the SEBI as 'foreign portfolio investors' are permitted to purchase debt capital (structured as non-convertible debentures) issued by Indian borrowers. Debt issuances in this manner are not: (a) limited by pricing restrictions on sale/redemptions, and (b) subject to reporting requirements. On the flipside, a single foreign portfolio investor is not permitted to purchase in excess of 50% of the debt issued by Indian entities. Typically, investment returns are structured as interest payments and upsides on sale/redemption.

Alternative Funding Structures

Foreign investors can structure their long-term commercial lending strategies in India by setting up/purchasing 'non-banking financial companies' (NBFCs). NBFCs are RBI regulated entities categorized on the basis of parameters like liability, size and activity, and are subject to requirements on minimum capitalisation, capital adequacy and prudential norms.

As NBFCs are Indian entities, financing options by NBFCs offer greater structuring and investment flexibility. However, setting up an NBFC is a long lead-time action and typically involves a timeline of ~6-8 months (and extensive paperwork). Foreign investors going down this road acquire existing NBFCs, as timelines are significantly shorter (~2-3 months); however, such acquisitions are subject to prior RBI approvals. Foreign investors proposing to route their investments through NBFCs should consider: (a) minimum capital requirements, and (b) Indian income tax incidence on investment returns.

Alternatively, foreign investors can also set up privately-pooled investment vehicles in India (termed as 'alternative investment funds' or AIFs). AIFs are mandatorily required to be registered with the SEBI and are categorized depending on nature of investments and investment strategy. Foreign investments into AIFs are subject to a lesser degree of compliance (in addition to certain AIF structures being more tax effective when compared to NBFCs). However, certain categories of AIFs are not permitted leverage and have mandatory investment diversification requirements.

Structuring Options: Given Indian exchange control restrictions on security creation in favour of foreign non-bank lenders, foreign investors purchasing debt capital of overseas entities which have underlying Indian revenue generating assets can: (a) execute contractual arrangements restricting transferability of the assets and stock of the Indian companies, and (b) up-stream decision making on key governance items relating to the Indian entities (to their overseas holding companies), where the foreign investors can have necessary veto rights.

Overseas listing

The Indian government has recently announced regulations permitting Indian companies to directly list their securities on overseas stock exchanges, marking a significant departure from the existing regime, which only permitted Indian companies to indirectly access overseas equity capital markets by issuing depository receipts. As underlying regulations are awaited, requirements on eligibility/qualification, jurisdictions and stock exchanges where listing may be undertaken, mandatory listing in India and 'cross-listings', etc., remain unclear.

Overseas listing on stock exchanges in jurisdictions like the US, UK, Singapore, Hong Kong and Japan will enable Indian companies to tap into broader pools of capital. In particular, Indian companies with private equity participation will look to list their securities on overseas exchanges to open up exit avenues for its investors. Separately, Indian companies operating in specialized sectors (e.g. technology) will also be able to access a more sophisticated investor pool in highly evolved jurisdictions like the US.

The US capital markets are highly liquid and can provide a deep resource of liquidity for global offerings. Under US regulations, the pathway for foreign private issuers is well established through a regulatory paradigm that allows entities that are incorporated or organized outside the United States where more than 50% of the voting securities are held by non-US residents and meet additional criteria. There are a number of substantial regulatory benefits for Indian companies seeking to list their securities in the United States that separate those issues from US domestic issuers, including the ability to use an accounting standard that is not US GAAP compliant, different reporting requirements, exemptions from US proxy rules and exemptions from Sarbanes-Oxley. Foreign private issues typically utilize the American Depository Receipts (ADRs) that are issued through a depositary.

The USA

US securities laws provide a disclosure-based framework for the offer and sale of securities. These laws are broad in scope and interpretation. The US public markets provide a mechanism to raise capital through a registration process which allows access to these securities to both institutional and retail investors. As discussed above, for the largest Indian companies, there is a well-established process to access the US public markets. The US private capital markets also provide a means for Indian companies to raise substantial capital. Private offerings in the US offer issuers the benefit of avoiding registration of the offering with limitations on (a) who can be investors in the offering, and (b) the ability for investors to resell the securities sold in private offerings, among other criteria.

When raising debt capital in the US through private transactions, Indian companies and other foreign issuers may avail themselves under certain “safe harbors” from registration under Regulation S or Rule 144A. When raising capital through private markets, issuers seek to avail themselves of exemptions from registrations. In multinational private capital transactions, the non-US aspects of the sale are governed by Regulation S (Reg S) under the Securities Act of 1933. To qualify for Reg S and, therefore, be exempt from registration, offers and sales must occur outside the US, regardless of whether the buyers are US or foreign investors. The two basic requirements of Reg S are: (a) the offer and sale must be made in an ‘offshore transaction’, and (b) there are no ‘directed selling efforts’ in or into the US of the offered securities. The Reg S “safe harbors” are available for foreign transactions under Rules 903 and 904. Rule 903 applies to issuers, distributors, and their affiliates while Rule 904 applies to the resales abroad by anyone not affiliated with the issuer or distributor, other than officers and directors of the issuer.

For issues making a private placement in the US, Rule 144A provides a “safe harbor” for resales of securities that meet certain requirements to specific qualifying buyers. Rule 144A applies only to the resale of securities. As such, issuers are not able to directly utilize the exemption. However, under Rule 144A, financial intermediaries may buy unregistered securities from an issuer and resell them to certain qualified institutional buyers (QIBs). Generally, QIBs are large institutional investors that own or invest at least $100 million worth of securities. QIBs may then sell unregistered securities to other QIBs in the US or offshore under Reg S. However, the securities sold under Rule 144A are considered restricted and cannot be sold to the public without registration or qualifying for an exemption.

One feature of the US debt markets that is unique from the India perspective is the ability to undertake a leveraged buyout. In a leveraged buyout, the buyer is able to finance the transaction in whole or in part by collateralizing the assets of the target to secure debt financing. The leveraged buyout fuels the ability of financial investors such as private equity firms, family offices and hedge funds to make acquisitions utilizing debt financing that would otherwise be unavailable to them in the absence to utilize the targets assets in this fashion. Debt financing for acquisitions in the United States are provided by regulated commercial banks and a large array of non-bank lenders. The US leveraged finance market since the financial crisis in 2008 and 2009 has been driven in large part by hedge funds and private equity debt providers. A boom in M&A activity in the United States during the past decade has led to increased leverage for privately held companies. With the financial uncertainty caused by the global pandemic, these capital structures may well come under pressure due to reductions in the financial performance of the underlying targets. Notwithstanding these risks, the leveraged buyout activity remains robust in the US in late 2020.

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About Cyril Amarchand Mangaldas

India's Leading Law Firm, Cyril Amarchand Mangaldas takes forward the values going back over 100 years, of the erstwhile Amarchand & Mangaldas & Suresh A. Shroff & Co. The Firm has over 750 lawyers, including 137 partners, and offices in India's key business centres. The Firm advises a large, and varied client base that includes domestic and foreign commercial enterprises, financial institutions, private equity funds, venture capital funds, start-ups and governmental and regulatory bodies. The firm received "Law Firm of the Year 2020" at the ALB India Law Awards and the Asialaw Regional Awards. The Firm was named "Most Innovative National Law Firm of the Year – India" at the IFLR Asia Awards.

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With more than 600 attorneys worldwide, Kilpatrick Townsend & Stockton LLP serves clients throughout the U.S., Europe, and Asia, bringing expertise in corporate transactional, intellectual property and litigation matters. India is a critical market for our clients and we have substantial experience in representing non-U.S. clients in their investing activity in the United States. Our integrated connectivity gives us the accessibility required to successfully handle our clients' complex national and international interests, while creating the best solutions worldwide.

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