Debt Funding in India Series

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MODES OF FUNDING: AN INTRODUCTION

Debt funding has often been preferred as the investment option for global investors. This is due to multiple reasons, including downside protection on investment, easy repatriation and efficiency from a tax perspective (both for the lender and the investee / borrower). In addition, structured debt investments also provide the lender equity upside, while continuing to provide the benefits of a pure debt investment.

The Indian regulatory regime provides for various routes for debt investment into India, with each route having its own set of benefits and challenges. In this article, we briefly give an overview of each of the various options for investors for making debt investment into India.

BACKGROUND

The Indian regulatory regime permits foreign investors to make debt investments into India through multiple routes. Some of these are through onshore vehicles (whether captive or third party), and others directly from offshore.

Onshore debt investment options, namely non-banking financial companies ("**NBFC**"), asset reconstruction companies ("**ARC**") and alternative investment funds ("**AIF**") provide relatively more flexibility to lenders and borrowers to structure the debt investments, but are sought with challenges with respect to repatriation, tax inefficiency and minimum capitalization norms. On the other hand, offshore models (like investment through foreign portfolio regime ("**FPI**"), foreign venture capital investment and external commercial borrowings) may be preferred from a post-tax returns and repatriation perspective, but are faced with challenges from an exchange control and flexibility of structuring perspective.

In this part of our 'Debt Funding in India' series, we have elaborated on each of the options briefly. Our following pieces in this series will deal with each of these options in more detail.

ONSHORE OPTIONS

Generally onshore debt funding options entail foreign investors / lenders investing into Indian entities, which on-lend the proceeds to the ultimate borrower(s). The Indian vehicle acts as an intermediary or a via-media, and is efficient from a structuring perspective, since the ultimate lending is by a resident entity. Some of these vehicles are also at par with the offshore funding models from a taxation standpoint, and offer good alternative routes for investment to offshore investors, especially global debt funds. These onshore vehicles are as explained below in brief.

1. Non-banking financial companies

Non-banking financial companies ("**NBFC**") are Indian companies registered with the Reserve Bank of India ("**RBI**") under the provisions of the RBI Act, 1934 ("**RBI Act**"). NBFC may be registered for a number of financing activities, including lending. NBFCs are engaged in retail lending as well as non-retail (corporate) lending. NBFCs are categorised based on their primary business, the asset size, as well as based on whether they accept deposits or not.

Foreign investors may chose various options for investment through NBFCs. These depend on the short-term and the long-term goals of the investors.

- Captive NBFC: First, acquisition / registration of an NBFC in India, and using such an NBFC for on-lending purposes is one such option. Pure debt funds find this option unattractive due to the lack of short term returns. In addition, this option is not very tax efficient, since the income or return of the NBFC is subject to taxation in India. However, this strategy of debt financing is very popular for debt investors looking at a growth play, and ultimately intend to sell the entire NBFC with its loan portfolio to a strategic player, or take the NBFC public by listing on a recognised stock exchange in India. This option is a long-term play, and as mentioned above, may not provide the investor short term returns.
- On-lending NBFC: Second, using an Indian NBFC as an intermediary entity for on-lending is another option often used. In this option, investors either use a third-party NBFC or a captive NBFC, i.e. an NBFC set up / acquired by it. The NBFC acts as an intermediate, borrowing from the foreign investor and on-lending the funds to domestic borrowers. For substance and tax purposes, a margin or spread is retained / charged at the Indian NBFC's level. This option may be preferred when investors are looking at a yield play, since the immediate returns are passed on to the investors offshore. Additionally, the option may also be considered in a growth play, since the lending by the NBFC continuously helps expand the loan book of the NBFC as well. This option is preferred to the option above from a tax perspective as well, since the NBFC is taxed only on the margin or spread.[1]
- Securitisation: A third alternative which has gained significant traction in the recent past is the practice of NBFCs originating / generating loans and securitising the same. The pass-through certificates issued by the securitization

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trusts are acquired by foreign investors directly, thereby providing them an indirect exposure to the Indian debt markets. This option is preferred since (a) it provides investors exposure to the Indian markets, (b) provides an option for easy repatriation, (c) is tax efficient, and (d) ensures the lending NBFC (originator) retains 'skin in the game', including by acting as the servicing agent for these loans. In addition, this is model is beneficial to the NBFC as well, since the structure may be used on a revolving basis by the NBFC for the purpose of the generation of loans, without swelling up its liability side of the balance sheet enormously.

2. Alternative investment funds

Alternative investment funds ("**AIF**") are investment funds registered with the securities regulator, Securities and Exchange Board of India ("**SEBI**"). AIFs are Indian entities, and hence have more flexibility with respect to debt investment from an Indian regulatory perspective.

However, AIFs are permitted to only invest in securities, and cannot have any direct loan exposure. Accordingly, AIFs largely lend by way of debenture instruments, be it optionally convertible, non-convertible or fully convertible. Depending on the residential status of the manager or the sponsor under Indian exchange control regulations, the investment by the AIF into portfolio companies may be considered resident investment or indirect foreign investment. However, AIFs are regulated by SEBI, and have some conditions to comply with. From a tax perspective, income earned by an AIF is generally a complete pass through, thereby ensuring that this mode of investment does not add another layer of tax for the foreign investor.

3. Asset reconstruction companies

Asset reconstruction companies ("**ARC**") offer another lucrative opportunity for foreign investors to invest in the Indian distressed debt market. Investment through ARCs are generally secondary transactions, whereby the ARCs acquire the existing loan exposure of lenders (generally banks or NBFCs) in borrowers. ARCs are registered with the RBI under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 ("**SARFAESI**"), and are permitted to acquire only sub-standard or non-performing loans. Accordingly, this mode of investment is preferred for distressed investors. The modus operandi includes acquisition of loans by ARCs into trusts set up by the ARC, referred to as asset reconstruction trusts, which issues units called security receipts (similar to pass-through certificates) which are acquired by foreign investors. The security receipts are also provided complete pass through, which make ARCs a preferred mode of investment for distressed investors. In addition, to mushroom ARCs, various sops such as reduced stamp duty, easier registration charges and tax benefits have been provided to ARCs.

4. Venture debt

The most recent form of investment into Indian companies, venture debt has evolved in the last 3 – 5 years. In its most commonly used form, venture debt entails investment by venture debt funds with valuations linked to the next round of fund raise by the portfolio, providing the venture debt fund suitable security and coupon, in addition to (at times) equity kickers or rights to invest / convert.

OFFSHORE OPTIONS

Certain debt investors prefer direct funding options to onshore models for debt investment. Such preference is due to direct control over the enforcement and exercise of rights, currency exchange risk or from tax efficiency perspective. These options are dealt with below.

1. Compulsorily convertible debentures – Foreign direct investment

Foreign investors are permitted to invest into compulsorily convertible debentures ("**CCD**") issued by Indian companies under the foreign direct investment route ("**FDI**"). While these CCDs are debt instruments, foreign investors are not allowed to repatriate the funds from India, and the investment is on a non-repatriable basis. The CCDs are required to be converted into equity shares mandatorily, as the name suggests, and pricing norms apply (i.e. minimum price at which investment can be made, and maximum price at which investment can be exited). The CCDs or the equity shares issued upon conversion can be transferred by the investor. CCDs are generally used where the lenders have a long term bullish view in relation to the investee company, and intend to convert their exposure to equity exposure at some time in future. As opposed to pure equity, CCDs permit lenders to extract some cash (as interest) on an annual basis in a tax efficient manner, and may also be used to provide the investor / lender contractual protections such as anti-dilution and liquidation preference.

2. Rupee denominated lending – foreign venture capital investment

SEBI registered foreign venture capital investors ("**FVCI**") are permitted to invest in debt instruments issued by Indian companies engaged in specified sectors. These investments can be by way of optionally, compulsorily or non-convertible debentures. The FVCI route permits investment into only 11 specified sectors, including infrastructure and information technology. Investment into NCDs by FVCIs can be made only in companies where the FVCI already has equity or equity linked instruments (optionally or compulsorily convertible instruments), and cannot exceed 33% of the total investment by the FVCI.

FVCIs are a preferred option for some investors since this is the only route under which foreign investors are permitted to directly invest in optionally convertible debt instruments. Further, FVCIs are not subject to the pricing norms applicable in case of CCD or FDI, and hence is a critical tool for structuring as well. FVCIs are most favourable in the infrastructure sector, where investors use the FVCI for setting up / capitalizing the investee company with nominal capital, and investing the bulk of the investment as debt in the form of optionally or non-convertible debentures.

3. Rupee denominated non-convertible debentures - Foreign portfolio investment

The most preferred offshore route for foreign investors has been the non-convertible debentures ("**NCD**") route. Under this option, investors registered with SEBI as foreign portfolio investors ("**FPI**") can acquire Rupee denominated non-convertible debentures issued by Indian corporates directly. These NCDs could be listed or unlisted. Unlisted NCDs have certain end-use restrictions, such as real estate business and investment in capital markets. However, recent regulatory changes require each FPI (at a group level) to not acquire more than 50% of the issuance of a single

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tranche of NCDs, thereby making this option unviable for structured or negotiated transactions. In situations where the abovementioned condition can be met, this option is still most preferred for investors.

To allay some of the concerns of foreign investors with respect to the 50% requirement, another route has been introduced for FPIs to invest into NCDs under. This is the voluntary retention route ("**VRR**"), whereby FPIs can invest in NCDs, provided the investment is retained in India for a period of at least 3 years. This essentially means that while the NCDs may be redeemed by the borrowers within the 3 year period, the amounts remain in the Indian account of the FPI for a period of 3 years. The intent is to ensure long term stable capital inflows into the debt market. This option has been preferred by a large number of investors who have a long term horizon for investments into India.

The NCD option is preferred since the route (a) permits security creation in favor of a resident trustee (on behalf of the investor), (b) provides free transferability of the NCDs, (c) is efficient from a tax perspective and (d) permits tracking underlying stocks and investors can be passed on the equity upside as well, by building in adequate equity kickers for investors, for example, as redemption premium or varying interest / coupon.

4. External commercial borrowing – Rupee denominated or foreign currency

Another viable option for debt investment into India, and used extensively by foreign banks and financial institutions is the external commercial borrowings ("**ECB**"). ECBs can be Rupee denominated or foreign currency denominated. The possibility of foreign currency denominated lending makes this option preferable for certain lenders. However, the ECB policy imposes certain cumbersome conditions such as the minimum average maturity period (the minimum period for which the loan has to be availed at the time of borrowing) and the all-in-cost ceiling (the maximum amounts that can be paid by the borrower to the lender). Certain forms of ECB has been given preferential tax treatment as well, making it a better option than other forms of debt funding for investors where the other conditions can be met.

The requirement of a longer tenure and a lower return make this route most suitable for foreign banking institutions (with LIBOR and other rates being lower than the all-in-cost ceiling), social impact funds and global funds engaged in sectors like infrastructure, which have a long gestation period, including pension funds and sovereign funds.

GLOBAL FUNDS: DEBT INVESTMENT STRUCTURES

Regulatory arbitrage has prompted serious long-term debt players in India to look at multiple options mentioned above. Various offshore players have within their group folds, FPIs or FVCIs for offshore investment, while AIFs or NBFCs for onshore investment Having multiple entities in the group structure provides such investors various options for investment to suit the structural needs of the transaction.

For instance, the presence of an NBFC or an AIF permits negotiated FPI investment transactions, with 50% of the NCDs held by the FPI, and the balance 50% held by the AIF / NBFC. Additionally, having an ARC and an FPI within the fold implies that ARCs can acquire distressed loans from the market and securitise them, with the FPI acquiring majority of the security receipts (pass through-certificates.

The decision of what entities (in case of multiplicity) to use depends on the synergies provided by the various entities on the one hand, and the long term outlook of the investor, the asset class for investments, the expected return and the tax efficiency on the other.

We will be dealing with each of these options in detail, along with some of the key challenges faced by the market participants in detail in various pieces in this series.

Debt Funding Team