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Impact of Latest FDI Regime on M&A and the Bharti-MTN Deal

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Author

Priti Suri

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Introduction

Foreign direct investment (FDI) is essential for the long-term economic development of any state. It not only facilitates capital inflow, but also enhances the competitiveness of the domestic economy. FDI is considered an indispensable tool for the Indian economy and the government monitors all inflow through its specialized departments. Investment is brought into India by two means. The first is the approval route, whereby prior approval from the Foreign Investment Promotion Board (FIPB) is required before making any investment. The second is the automatic route, whereby no approval from the FIPB is required, provided that the intended investment fulfils the applicable criteria. Thereafter, the Reserve Bank of India must be informed within 30 days of inward remittance and the necessary documents must be filed with the Reserve Bank of India within 30 days of shares being issued to foreign investors.

New FDI Norms

On February 13 2009 radical changes were made to the FDI norms in anticipation of increased foreign investment. The Department of Industrial Policy and Promotion issued Press Notes 2/2009 and 3/2009 and issued further clarifications on February 25 2009 through Press Note 4/2009, which clarify, expand upon and modify the various previous policies and the method of calculating direct and indirect foreign investment. Briefly, under the February press notes, the dual criteria to determine whether foreign holding is to be treated as FDI are management and economic control.

Press Note 2/2009 states that a company will be considered 'owned' and 'controlled' by an Indian company where more than 50% of the equity in such Indian company is owned by resident Indian citizens and Indian companies which are, in turn, owned and controlled by resident Indian citizens who have the power to appoint a majority of the company's board directors. Press Note 2/2009 also clearly differentiates between direct and indirect investment. It stipulates that if an Indian company is owned and controlled by resident Indians or Indian companies, its investment in other Indian companies will not be treated as indirect foreign investment, even if it has foreign shareholders. Alternatively, if an Indian company investing in another Indian company is owned or controlled by a non-resident entity, its entire investment will be considered as indirect foreign investment.

Direct investment, on the other hand, is any investment made directly by non-resident entities into an Indian company. Prior to issuance of the February press notes, total foreign investment in a company was calculated by a sum total of direct and indirect investment.

Indirect investment was always calculated on a proportionate basis. That is, if the direct investment by a non-resident entity in an Indian company was, for example, 30% and the Indian company, in turn, made a downstream investment of, for example, 80% in another Indian company, the indirect investment in the latter was 24% (80% of the initial 30%). This situation has now changed. In a sector which has an FDI cap, where Indian companies (with foreign investment below 50%) make further downstream investment in other Indian companies, all such downstream investment will be considered as Indian investment. Alternatively, where the Indian company is owned or controlled by a non-resident entity, the repercussion is that the entire downstream investment will be termed as foreign investment and the sectoral ceilings will apply.

Press Note 3/2009 provides that for the assessment of FDI, foreign investment will now

include investment by:

- foreign institutional investors;
- non-resident Indians;
- American depositary receipts;
- global depositary receipts;
- foreign currency convertible bonds;
- convertible preference shares; and
- convertible currency debentures.

These forms of investment were previously assessed separately. Press Note 3/2009 further makes it mandatory to procure FIPB approval in two specific situations: (i) where investment is made in an Indian company operating in a sector with caps, provided that the Indian entity is owned and controlled by a non-resident entity; and (ii) where the control or ownership of an existing Indian company is transferred by resident Indians and companies to a non-resident entity as a consequence of a transfer of shares through a merger or amalgamation. Previously, in cases of such transfer investors were required only to report the inward remittance to the Reserve Bank of India within 30 days of receipt of funds and file the required documents within 30 days of issuing shares to the foreign investors.

Press Note 4/2009 elucidates the new guidelines for downstream investment by Indian companies and, specifically, operating companies (ie, those companies undertaking operations in various economic sectors and activities), investing companies (ie, those companies holding only investments in other Indian companies, directly or indirectly) and operating-cum-investing companies, which are owned or controlled by non-resident entities.

Previously, an Indian holding company with foreign investment required an investing company or investing-cum-operating company to seek approval from the FIPB before making further downstream investments. However, the new guidelines eliminate this requirement for prior FIPB approval, subject to sectoral caps and conditions being met. In other words, foreign investors can invest less than 50% in an Indian operating-cum-investing company controlled by resident Indians and use it to make downstream investments in other Indian companies without prior approval. In such cases the indirect foreign investment will not be counted for sectoral cap purposes. This will simplify foreign investment calculation - allowing companies to raise capital from anywhere, provided that they are Indian owned and controlled - and make it easier to make downstream investments.

However, foreign investment in investing companies and companies which have no operations and no downstream investments will continue to require prior FIPB approval, regardless of the amount or extent of the foreign investment. Further, as and when such companies with no operations and downstream investments commence business or make downstream investment, they must comply with the relevant sectoral conditions and caps.

Potential Impact of Press Notes on Proposed Bharti-MTN Deal

The Indian media has recently been full of reports about the speculated strategic merger between Bharti Airtel, India's largest mobile operator, and MTN, South Africa's telecommunications giant. Talks between the two parties failed last year, but the world's financial environment is very different now from how it was in May 2008. Media reports indicate that the proposed strategic merger will be worth $23 billion - the largest telecommunications merger in history.

With no direct knowledge of the transaction, and based on media reports and financial analysts' speculation, it seems that if the MTN deal concludes successfully, Bharti will try and keep enough room for further foreign investment.

According to media reports, Bharti will acquire a 49% stake in MTN through a combination of share transfer and fresh issuance, and MTN and its shareholders will acquire a total of 36.37% in Bharti by proportionately reducing the stake of Bharti Telecom (BT) in Bharti. Assuming that this will be the proposed transaction structure, it is pertinent to examine the impact of Press Note 2/2009 on this deal.

Presently, BT owns an approximate 45.3% stake in Bharti and is its largest shareholder. The foreign holding in BT is a little over 40%, with the largest foreign investor, Singapore telecommunications company SingTel, owning approximately 28%. Therefore, prior to the issuance of Press Note 2, SingTel's proportionate ownership in Bharti would have been calculated at 12.86% (28% of 45.3%). Upon conclusion of a successful deal between Bharti and MTN, the latter will hold 36.37%, while the remaining shareholders will hold 63.63%. Hence, BT's pre-transaction stake of 45.3% in Bharti will become 45.3% of the remaining 63.63%, amounting to 28.82%. SingTel's post-closing stake will become 8.17% (ie, 12.86/45.30 x 28.80).

Similarly, Vodafone presently owns almost 10% in BT and, hence, owns approximately 4.5% *pro rata* in Bharti (10% of 45.3%). Given that BT's post-closing stake in Bharti

would become 28.82%, Vodafone's post-closing stake would in turn become 2.8% (ie, 4.5/45.30 x 28.8).

Since BT's Indian promoters own more than a 50% stake in Bharti, BT's stake in Bharti will not be counted when calculating indirect foreign investment. Therefore, the indirect foreign holding (ie, SingTel and Vodafone's pre and post-transaction stakes described above) will be excluded pursuant to Press Note 2. This will provide ample opportunity for Bharti to seek further foreign investment. Bharti already has approximately 20% foreign institutional investors and, hence, coupled with the proposed shareholding of 36.37% by MTN, the total foreign investment in Bharti will be 56.37%, which is in excess of the current threshold limit of 49% for the telecommunications sector. As a result, once the deal structure is finalized, the parties will need to ensure that they seek FIPB approval of the transaction.

At present, there is no sound basis for comment on the deal structure, as no official statement by Bharti or MTN has been released. According to media reports, the parties will continue to discuss and negotiate on the deal structure until the end of July 2009. Until then, only speculations and assumptions can be made. However, as is apparent, the parties will have to ensure that the transaction structure minimizes the need for government intervention and approvals. To that end, retaining ownership and control with Indian companies and Indian residents will be of paramount importance.

Comment

The new FDI guidelines provide a uniform framework for calculating foreign investment and are certainly a step forward in liberalizing FDI norms. However, they have created significant confusion and controversy, since many companies and banks in India, which had majority ownership by non-residents, will now be considered foreign-owned for the purpose of any downstream investment. Further, the press notes do not address the situation of a 50-50 joint venture where the foreign and Indian investors have equal board control of an investing company. The Reserve Bank of India and the Ministry of Finance have asked the Department of Industrial Policy and Promotion to issue further clarifications. This means that both Bharti and MTN will also have to be prepared for any last-minute changes and amendments to the existing FDI norms.

For further information on this topic please contact Priti Suri at PSA, Legal Counsellors by telephone (+91 11 4350 0500), fax (+ 91 11 4350 0502) or email (p.suri@psalegal.com).

Dhruv Suri assisted in the preparation of this update.

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