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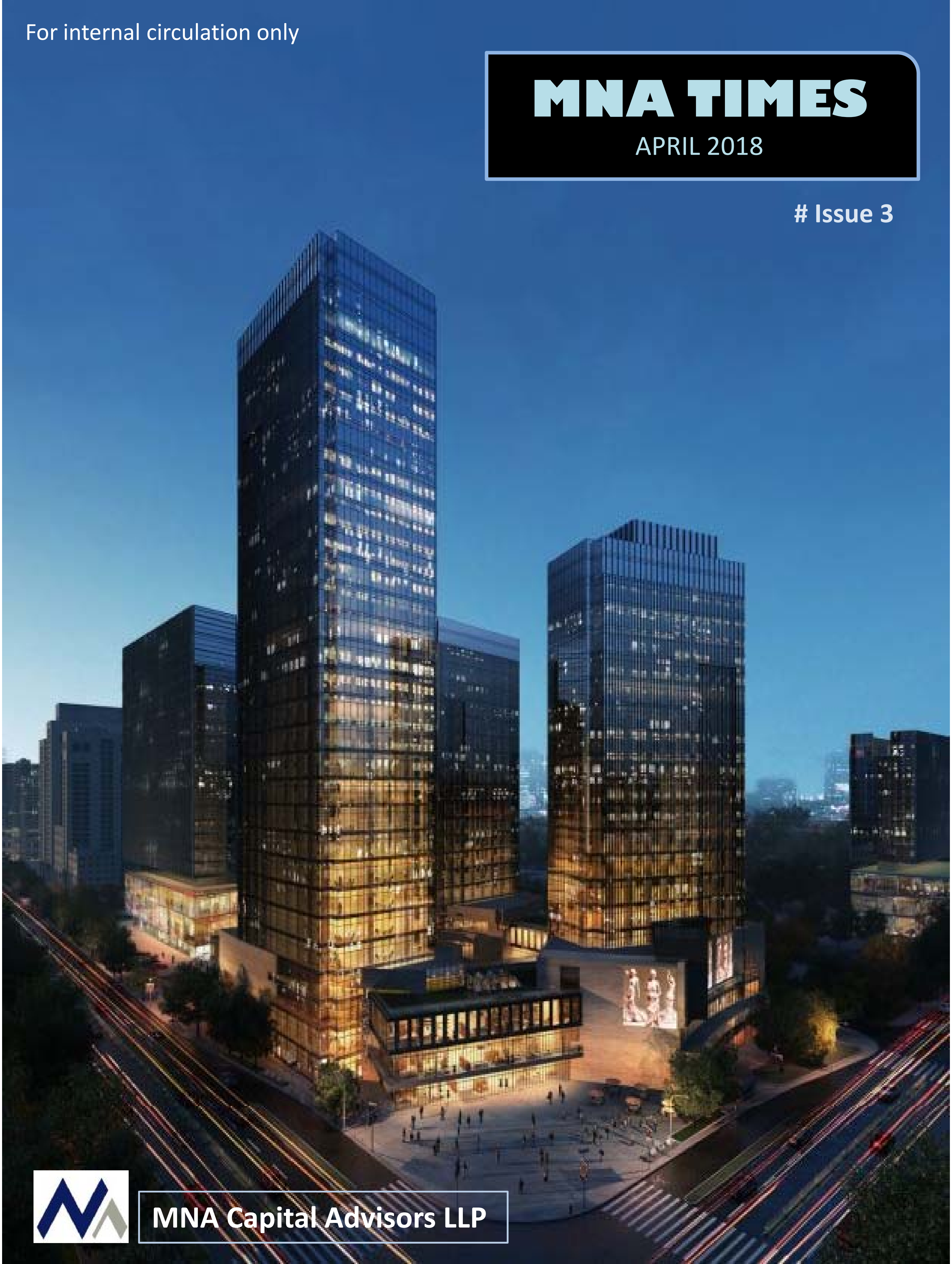
MNA TIMES

APRIL 2018

 # Issue 3



MNA Capital Advisors LLP

PREFACE

Dear Clients / Friends,

"The industry is going through a phenomenal period of change!"

This has become a common statement across almost all sectors now – retail, media, financial services, social networks and very recently, advertising agencies. With the exit of Sir Martin Sorell, the iconic leader of agency giant WPP, the advertising industry (already facing cost pressure) is expected to see a major shake-up. In fact WPP has already lost USD 1 Bn of market cap in these few days. A great business plan needs a great leader and vice versa. It also highlights the importance for owners to have a "**succession plan"** in place. On this front, Microsoft and Google may have done a good job moving the needle to Satya Nadela and Sunder Pichai, respectively. In India, we rarely see promoters leaving control, even in cases where the company is under serious issues, including bankruptcy. Further, questions relating to governance on professional stalwarts in India could also dampen the process of succession planning. This is a matter of debate and evolution!

Moving to the our updates, the following are the highlights of this issue:

Deals for the month of March - We have noticed a momentum in M&A activities especially in the consumer, IT and Financial services which includes investor exits to strategic buyers in several cases. Like we pointed in our last newsletter, content remains an active play for telcos and e-tailers and we don't foresee the trend slowing down.

Cross Border Merger Rules - The notification of FEMA regulations laying down the framework in relation to cross border mergers is an extremely positive development, which should facilitate international merger and acquisition transactions .

The Bankruptcy Code – This area has become more of a legal mandate then for the intended commercial benefits. We have included an article which deals with issues with the Code.

GST–As issues around GST and E-way bills appear to be stabilising, we have included an article which talks about the impact of GST in M&A.

Ind AS – The RBI has deferred the applicability to Banks by another year, however, they have remained silent on its applicability to NBFC citing jurisdiction of MCA. Meanwhile, we bring out the summary of recent amendments to Ind AS.

Other Articles – We have included an article explaining the practicability of the 2 tier structure rule for companies as per the Companies Act, 2013; Also, we have included an article which explains the concept of a Leveraged Buy Out (LBO).

Reports Column – In this edition we have included the following reports:

- Travel and Hospitality Industry gone digital –FICCI, March 2018
- Affordable Housing : The Next Big Thing – FICCI, March 2018
- Transformation of on-road automobiles to electric vehicles in India – KPMG, March 2018
- Top 20 reasons why Startups fail – CBInsights, March 2018

We hope you enjoy reading this issue. We will be delighted to hear from you on any suggestions.

-Team MNA

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Deals reported in March 2018

Source : Vccedge

MNA Capital Advisors LLP

Sr. No	Target Company Name	Buyer (s)	Seller (s)	Deal Value ($ mn)	% Sought	Sector
1	Max Life Insurance Co. Ltd.	Max Financial Services Ltd.	Axis Bank Ltd.	23.47	0.74	BFSI
2	Arohan Financial Services Pvt. Ltd.	NA	Dell Foundation	2.30	NA	BFSI
3	NDA Share Brokers Ltd.	Ess Kay Mercantiles Ltd., Path Finders	NDA Securities Ltd.	0.26	36.19	BFSI
4	Liberty General Insurance Company Ltd.	Diamond Dealtrade Ltd., Enam Securities	Videocon Industries Ltd.	NA	51.32	BFSI
5	SV Creditline Pvt. Ltd.	ICICI Prudential Life Insurance Company Ltd.	NA	NA	7.60	BFSI
				26.03	BFSI Total	
9	Sula Vineyards Pvt. Ltd.	NA	Reliance Capital Ltd.	39.49	19.05	Consumer
7	HMCL Columbia SAS	Hero MotoCorp Ltd.	N.A.	10.50	0.68	Consumer
8	Bellezimo Professionale Products Pvt. Ltd.	Promoters of the company	Marico Ltd.	0.25	45.00	Consumer
13	Satyanarayan Rice Mill Pvt. Ltd.	Orient Beverages Ltd.	NA	0.18	100.00	Consumer
6	Ramesh Flowers Pvt. Ltd.	Gala Kerzen GMBH	NA	NA	70.00	Consumer
10	Vegico Foods Pvt. Ltd.	Narendra Investments Delhi Ltd.	Fudkor India Pvt. Ltd.	NA	100.00	Consumer
11	Fudkor India Pvt. Ltd.	Narendra Investments Delhi Ltd.	NA	NA	51.00	Consumer
12	Future Consumer Ltd., Non-Core Investments	Shubham Business Ventures Pvt. Ltd.	Future Consumer Ltd.	NA	100.00	Consumer
				50.42	Consumer Total	
15	Callido Learning LLP	UK-based Publisher	NA	2.00	NA	Education
14	Zeus Education Pvt. Ltd.	Think and Learn Pvt. Ltd.	NA	1.00	NA	Education
16	Amelio Early Education Pvt. Ltd.	Babilou Group	NA	NA	NA	Education
				3.00	Education Total	
17	Golden Drugs Pvt. Ltd.	Bal Pharma Ltd.	NA	NA	100.00	Pharma
				0.00	PharmaTotal	
18	Towell Take Investment LLC	Confide advisors Pte. Ltd.	Take Solutions Ltd.	2.00	51.00	Industrial
22	Al Sharif Group and KEC Ltd. Company	KEC International Ltd.	AlSharif Group	0.69	2.10	Industrial
19	Kashiram Jain and Company Ltd.	Newedge Vinimay Pvt. Ltd.	NA	NA	11.79	Industrial
20	Palladium Consulting India Pvt. Ltd.	NA	NA	NA	NA	Industrial
21	MFT Motoren und Fahrzeugtechnik GmbH	Precision Camshafts Ltd.	NA	NA	76.00	Industrial
23	Quality Iron And Steel Ltd.	Jindal Saw Ltd.	NA	NA	49.00	Industrial
				2.69	Industrial Total	
30	KaiOS Technologies Inc.	Reliance Retail Ltd.		7.00	16.00	IT
26	Neviton Softech Pvt. Ltd.	Universal Alloy Corporation	NA	4.54	NA	IT
32	WCFN Solutions Pvt. Ltd.	Head Infotech India Pvt. Ltd.		1.00	NA	IT
24	Algebraa Bookkeeping	R.Tulsian and Co.	NA	NA	100.00	IT
25	Accentium Web Pvt. Ltd., secondshaadi.com	Matrimony.Com Ltd.	Accentium Web Pvt. Ltd.	NA	100.00	IT
27	Innoveo AG	Servion Global Solutions Ltd.	NA	NA	100.00	IT
28	MotorWhiz Automotive Pvt. Ltd.	ChatPay Commerce Pvt. Ltd.	NA	NA	100.00	IT
29	Aetlo Tech Pvt. Ltd.	Page Solutions Ltd.		NA	100.00	IT
31	InfinyPool Online Payment Solutions India Pvt. Ltd.	Wibmo Inc.	Accel India IV LP, Investopad, Qualcomm Ventures, & Various	NA	100.00	IT
33	Shambhavi Tech Farms Pvt. Ltd.	Aggreen Tech Pvt. Ltd.	Elevar Advisors Pvt. Ltd., & various	NA	100.00	IT
34	Goyello Group B.V.	Aspire Systems India Pvt. Ltd.	NA	NA	100.00	IT
35	Silicon And Beyond Pvt. Ltd.	Synopsys Inc.	NA	NA	100.00	IT
				12.54	IT Total	
39	Edina Power Systems Ltd.	EESL EnergyPro Assets Ltd.	NA	75.65	100.00	Infra
37	International Cargo Terminals And Infrastructure Pvt. Ltd.	Krishna Kotak and family	IDFC India Infrastructure Fund	73.00	35.00	Infra
41	Vaibhavlaxmi Clean Energy LLP	Pristine Developers Pvt. Ltd.	NA	7.81	NA	Infra
36	Adani Energy Ltd.	NA	Adani Enterprises Ltd.	0.02	100.00	Infra
38	Reliance Naval and Engineering Ltd.	Vistra ITCL India Ltd.	SKIL Infrastructure Ltd and others	NA	18.82	Infra
40	Goa-Tamnar Transmission Project Ltd.	Sterlite Power Transmission Ltd.	PFC Consulting Ltd.	NA	100.00	Infra
42	WR-NR Power Transmission Ltd.	Power Grid Corporation of India Ltd.	REC Transmission Projects Company Ltd.	NA	100.00	Infra
				156.48	Infra Total	
45	Indiabulls Real Estate Ltd., Residential Township Project	Ozone Group	Indiabulls Real Estate Ltd.	43.74	100.00	Real Est
46	KGS Developers Ltd.	NA	Reliance Corporate Advisory Services Ltd.	12.65	14.90	Real Est
44	Kohinoor Planet Constructions Pvt. Ltd.	Real Gold Developers LLP	NA	7.13	NA	Real Est
43	HEM Infrastructure and Property Developers Pvt. Ltd.	Peninsula Land Ltd.	NA	2.20	6.43	Real Est
47	Navkar Builders Ltd.	NA	NA	NA	9.66	Real Est
				65.72	Real Est Total	
48	Saavn Media Pvt. Ltd.	Reliance Industries Ltd., JioMusic	Reliance Industries Ltd.	227.00	100.00	TMT
49	Gulf Bridge International Submarine Cable, India Operation	Bharti Airtel Ltd.	Gulf Bridge International	NA	100.00	TMT
				227.00	TMT Total	

The Foreign Exchange Management

(Cross Border Merger) Regulations, 2018

Source : PWC

Foreign Exchange Management (Cross Border Merger) Regulations, 2018

March 26, 2018

In brief

Section 234 of the Companies Act, 2013 (notified with effect from 13 April, 2017) provided for the cross border merger of Indian and foreign companies. Further, Companies (Compromises, Arrangements and Amalgamation) Rules, 2016, as amended by the Companies (Compromises, Arrangements and Amalgamation) Amendment Rules, 2017 (Co. Rules) were issued. Section 234 provides for prior Reserve Bank of India (RBI) approval in case of cross border merger.

On 26 April, 2017, the RBI issued draft regulations relating to cross border mergers for comments from the public**.**

The Foreign Exchange Management (Cross Border Merger) Regulations, 2018 have now been notified *vide* notification no. FEMA 389/ 2018-RB dated 20 March, 2018 and are effective from the date of notification.

As per the Regulations, merger transactions in compliance with these regulations shall be deemed to have been approved by RBI, and hence, no separate approval should be required. In other cases, merger transactions should require prior RBI approval.

In detail

A summary of the Regulations is given below in the context of inbound and outbound mergers.

Particulars	Inbound merger	Outbound merger
Definition	Cross border merger in which the Resultant Company is an Indian company.	Cross border merger in which the Resultant Company is a foreign company. The foreign company should be incorporated in a jurisdiction specified in **Annexure B** to Co. Rules.
Conditions for issue of security by the Resultant Company	• Compliance with FEMA regulations concerning inbound investments,[1] including pricing	• Compliance with FEMA regulations concerning outbound investments[2].

[1] Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2017
[2] Foreign Exchange Management (Transfer or issue of any Foreign Security) Regulations, 2004

Particulars	Inbound merger	Outbound merger
	guidelines, entry routes, sectoral caps, attendant conditions and reporting requirements. • Additionally, compliance required with FEMA regulations concerning outbound investments[2] in the following cases: – Where transferor foreign company is a joint venture (JV)/ wholly owned subsidiary (WOS) of the Indian company. – Where the merger results in acquisition of step-down subsidiary (SDS) of JV/ WOS outside India.	• Compliance with FEMA regulations concerning outbound investments[3]. • In case shareholder of transferor Indian company is a resident individual, the fair market value of foreign securities should be within the limits prescribed under the Liberalised Remittance Scheme.
Treatment of office of transferor company	• Any office of the transferor foreign company outside India will be deemed to be the branch/ office outside India of the resultant Indian company. • Relevant FEMA regulations to be complied with[4] post-merger.	• Any office of the transferor Indian company in India will be deemed to be the branch/ office in India of the resultant foreign company. • Relevant FEMA regulations[5] to be complied with post-merger.
Guarantees and outstanding borrowings of transferor company	• Guarantees and borrowings of the transferor foreign company from overseas sources, which become guarantees and borrowings of the resultant Indian company to comply with the relevant FEMA regulations. • Timeline of two years prescribed for above compliance. No remittance for repayment can be made within these two years. • Conditions with respect to end-use would not apply.	• Resultant foreign company should not acquire any liability payable to local Indian lenders, which is not in conformity with FEMA or guidelines issued thereunder - NOC to be obtained from lenders in India. • Guarantees and borrowings of the transferor Indian company to be repaid as per terms of the scheme that may be sanctioned by the National Company Law Tribunal (NCLT).
Bank account in country of transferor entity	• Resultant Company permitted to open a bank account in foreign currency in the overseas jurisdiction for putting through transactions incidental to the merger. • This bank account can be maintained for a maximum period of two years from the date of sanction by the NCLT.	• The Resultant Company is permitted to open a Special Non-Resident Rupee Account (SNRR Account) in accordance with relevant FEMA regulations[6]. • This bank account can be maintained for a maximum period of two years from the date of sanction by the NCLT.

[3] Foreign Exchange Management (Transfer or issue of any Foreign Security) Regulations, 2004
[4] Foreign Exchange Management (Foreign Currency Account by a person resident in India) Regulations, 2015
[5] Foreign Exchange Management (Establishment in India of a branch office or a liaison office or a project office or any other place of business) Regulations, 2016
[6] Foreign Exchange Management (Deposit) Regulations, 2016

<table>
<tr><th>Particulars</th><th>Inbound merger</th><th>Outbound merger</th></tr>
<tr><td>Acquisition/ holding of any other asset of transferor entity</td><td>Resultant Company permitted to acquire and hold asset outside India to the extent permitted under FEMA guidelines.
Asset or security not permitted to be acquired or held under FEMA guidelines should be sold within two years from the date of sanction by the NCLT.
Proceeds to be repatriated to India immediately on sale
Proceeds could be utilised for payment of an overseas liability not permitted to be held under FEMA guidelines within the two-year period.</td><td>Resultant Company permitted to acquire and hold any asset in India to the extent permitted under FEMA guidelines.
Asset or security not permitted to be acquired or held under FEMA guidelines should be sold within two years from the date of sanction by the NCLT.
Proceeds to be repatriated outside India immediately on sale
Proceeds could be utilised for repayment of Indian liability within the two-year period.</td></tr>
<tr><td>Other conditions</td><td colspan="2">Valuation
Valuation of the Indian company and the foreign company to be in accordance with Rule 25A of the prescribed Co. Rules, i.e., internationally accepted principles on accounting and valuation.
Compensation
Payment of compensation by the Resultant Company, to a holder of a security of the Indian company or the foreign company to be in accordance with the Scheme sanctioned by the NCLT.
Regularisation of non-compliances
Companies to ensure completing requisite regulatory actions prior to merger with respect to any non-compliance, contravention, violation under FEMA.
Reporting compliances
Certificate confirming compliance with above guidelines to be furnished by the managing director/ whole-time director and company secretary (if available) to be submitted to the NCLT.
Other reporting guidelines to be prescribed by the RBI in consultation with the Government of India.</td></tr>
<tr><td>Transition cases</td><td colspan="2">Merger cases pending before the competent authority as on 20 March, 2018 to be governed by the above guidelines.</td></tr>
</table>

Key definitions under these regulations

- “Cross border merger” means any merger, amalgamation or arrangement between an Indian company and foreign company, in accordance with Companies (Compromises, Arrangements and Amalgamation) Rules, 2016 notified under the Companies Act, 2013 *(Under the draft regulations, the word “demerger” was part of the definition of “Cross border merger.” However, the same has been deleted in the notified regulations*).
- “Foreign company” means any company or body corporate incorporated outside India whether having a place of business in India or not.
- “Indian company” means a company incorporated under the Companies Act, 2013 or under any previous company law.
- “Resultant Company” means an Indian company or a foreign company, which takes over the assets and liabilities of the companies involved in the cross border merger.

Issues in Insolvency and Bankruptcy Code, 2016

Source : ICAI Journal, April 2018

Issues in Insolvency and Bankruptcy Code, 2016

Corporate Insolvency Resolution Process mechanism under the Insolvency and Bankruptcy Code, 2016 (IBC) is slowly but steadily gathering steam. Since its introduction in December, 2016, over 750 applications under different provisions of IBC have been admitted by various benches of National Company Law Tribunal (NCLT), the adjudicating authority. However, as is the case with any new legislation, Insolvency Professionals as well as creditors are still grappling with some of the key provisions of IBC to interpret their true import. It would therefore be desirable if the Insolvency and Bankruptcy Board of India, the regulatory authority designated under IBC, clears the air on these issues as soon as possible or amendments are made to IBC where required. Read on to know more….

INTRODUCTION

The Insolvency and Bankruptcy Code, 2016 (IBC), since its implementation in December, 2016, has been widely acknowledged as a bold reform in the financial sector. The report of Banking Law Reforms Committee headed by Dr. T. K. Vishwanathan, which provided the framework for the law, envisages a scenario where in case of a default by the equity owners to meet their debt obligations, control is transferred to the creditors and equity owners take a back seat. The Committee noted that this is not how things work in India and promoters continue to control the entity even after defaulting on payments. In the recent years, this situation has been the cause of unacceptably high levels of stressed assets in the banking system and this, in turn, has threatened to shake the country's financial stability.

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Through this legislation, the Government has sought to rectify the situation. The prime objective behind IBC is timely resolution of transitory financial stress being faced by businesses, due to internal or external reasons, by way of restructuring of debt in cases where the existing owners clear the default. Where the stress is not due to financial reasons but owing to management failure or where the default is not cleared, change in ownership in a time-bound manner should be facilitated so as to prevent decay in value of assets. If the stress is owing to the business itself having become unviable, it should be allowed to go into liquidation. Additionally, IBC sets out to achieve multiple objectives including the following:

i. consolidating multiple legislations under one code with one Adjudicating Authority;
ii. facilitating lending without security in increasingly asset-light service sector dominated Indian economy;
iii. encouraging finance providers to lend money for risk-taking and entrepreneurship;
iv. creation of a vibrant bond market by empowering bondholders and

v. providing a forum to operational creditors to initiate insolvency proceedings, settle their dues fast.

The pace of applications filed under IBC is steadily gathering momentum. Through an amendment to Banking Regulation Act, Reserve Bank of India has been empowered to "*issue directions to any banking company to initiate insolvency resolution process in respect of a default, under the provisions of IBC.*" Also, the recent Circular of Reserve Bank of India scraps almost all the old schemes, viz., CDR, SDR, S4A etc. and mandates banks to find a resolution in large stressed accounts within 6 months. In case these cases remain unresolved, banks are required to refer those cases to NCLT under IBC. This will likely provide greater impetus to corporate insolvency resolution process (CIRP).

As is the case with any new legislation, IBC is giving rise to several questions. Insolvency professionals (IPs), a new community created under the code drawing from CAs and other professionals, is struggling to find answers to these questions. These are practical issues being faced by IPs, creditors and CDs alike and government would do well to come out with suitable amendment or notifications quickly in order to facilitate smooth transition to this new regime.

RISK OF DOMINO EFFECT

Under IBC, an operational creditor (OC) may, in case of default by CD, demand payment. If payment is not made within 10 days and there is no dispute, OC may file an application under IBC for CIRP. While the objectives of this provision are laudable inasmuch as it allows early detection of stress and its timely resolution, the unintended fallout in case of application being admitted would be that such admission will be followed by inviting claims from creditors. It is not unfathomable that such invitation by way of public announcement may lead to other suppliers and lenders hardening their stance in terms of credit terms, interest etc. fearing liquidation of the entity going ahead. Now, in a situation where the financial stress on the CD is temporary, initiation of CIRP may spell doom on its fortunes and render a viable business potentially unviable. In a larger national context, the costs of such forced disruptions on a growing economy can be debilitating. Adjudicating Authorities, therefore, have to move with caution before admitting an application.

Under IBC, an operational creditor (OC) may, in case of default by CD, demand payment. If payment is not made within 10 days and there is no dispute, OC may file an application under IBC for CIRP. While the objectives of this provision are laudable inasmuch as it allows early detection of stress and its timely resolution, the unintended fallout in case of application being admitted would be that such admission will be followed by inviting claims from creditors.

NOT SO ATTRACTIVE FOR FINANCIAL CREDITORS

It is probably the likelihood of the CD irretrievably going into liquidation that is holding secured financial creditors from proceeding under IBC in a big way. As it is, nearly 75% of CIRP cases have gone for liquidation. If such lenders have to enforce security, they can do so under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) even without going for IBC route. This right is available to them even during liquidation under IBC. Remember, in case of a resolution plan approved under IBC failing during implementation, there is no option but to liquidate the CD. Secured lenders thus continue to show preference for old ways which include restructuring, selling stressed assets to Asset Reconstruction Companies, one-time settlement in odd cases etc. This probably explains why only around one-fourth of the cases for insolvency resolution process admitted by NCLT benches are filed by financial creditors despite burgeoning non-performing advances.

RELUCTANCE TO ALLOW LARGE HAIRCUTS

Lack of interest for IBC route evinced by secured lenders so far also stems from their reluctance to take a haircut. Under IBC, a Committee of Creditors (CoC) may be required to take a call on extending waivers and concessions to the Corporate Debtor (CD). It is often the leader of the consortium who is expected to initiate such a move. In case of a single lender forming CoC, she herself has to take the call. Empirical evidence suggests that lenders avoid taking such decisions fearing questioning by vigilance and this may inevitably lead the debtor into liquidation.

To counter this tendency, bank officials who do not accept a haircut and lead the CD to liquidation should be questioned if realisations are lower in liquidation as compared to what was being offered in a resolution plan.

Secured lenders also need to be educated about the fact that it is better to rest management control with IP as resolution professional or liquidator than with the promoters while security enforcement proceedings take place. They also have to be educated that chances of change of management are far greater under IBC than when promoters control.

PRE-PACKAGED DEALS

Under the United Kingdom bankruptcy ecosystem, in a large number of cases, pre-packaging is done prior to starting IBC process. Thus, if a proposed IP gets an investor, packages the restructuring deal around the price the investor is willing to bid for and presents the same to FCs, they may get more inclined to go through IBC process. The law then acts only as a *post facto* facilitator when restructuring with new investor would have already been completed by IP before going through IBC process. In India too, IBC should ideally have similar provisions to allow pre-pack as a formal arrangement.

ACQUIRING VOTING SHARE TO BLOCK RESOLUTION-GOOD INVESTMENT STRATEGY?

In a situation where a canny investor, anticipating a resolution, buys unsecured financial debt in a stressed entity exceeding 25% of its total financial debt, she may gain a blocking voting right in any resolution plan at throwaway price. In a CoC meeting, she may be in a position to negotiate terms at par with secured lenders. The price of structurally subordinated financial debt will be much lower and recovery could become at par with secured financial debt to be able to vote in favour of resolution plan. Even in the case of the debtor going into liquidation, such investor may not lose much by virtue of her lower investment entry point. Not only this, she may even negotiate a deal with other lenders to buy out their stake at lower prices. This is a common practice in the United Kingdom and perfectly in accordance with their law. It would be interesting to see how these kind of deals plans out under IBC and how NCLT views them.

Under the United Kingdom bankruptcy ecosystem, in a large number of cases, pre-packaging is done prior to starting IBC process. Thus, if a proposed IP gets an investor, packages the restructuring deal around the price the investor is willing to bid for and presents the same to FCs, they may get more inclined to go through IBC process.

AMALGAMATION OR MERGER OF THE CD

IBC does not spell out in clear terms as to whether a resolution plan could provide for amalgamation/ merger of the CD with a potential investor. Assuming that the resolution plan meets all the other requirements stipulated in IBC, such amalgamation/ merger should be possible in the opinion of the author. Section 30(2) of IBC reads as under:

> *"The resolution professional shall examine each resolution plan received by him to confirm that each resolution plan—*
>
> *(a) provides for the payment of insolvency resolution process costs in a manner specified by the Board in priority to the repayment of other debts of the corporate debtor;*
>
> *(b) provides for the repayment of the debts of operational creditors in such manner as may be specified by the Board which shall not be less than the amount to be paid to the operational creditors in the event of a liquidation of the corporate debtor under section 53;*
>
> *(c) provides for the management of the affairs of the Corporate debtor after approval of the resolution plan;*
>
> *(d) the implementation and supervision of the resolution plan;*
>
> *(e) does not contravene any of the provisions of the law for the time being in force;*
>
> *(f) conforms to such other requirements as may be specified by the Board."*

In the case of the CD going into liquidation, on the other hand, Section 35(1)(f) comes into play which provides that subject to the directions of AA, the liquidator shall have following powers and duties, namely:

> *"........ to sell the immovable and movable property and actionable claims of the corporate debtor in liquidation by public auction or private contract, with power to transfer such property to any person or body corporate, or to sell the same in parcels in such manner as may be specified.*

Upon admission of an application for CIRP or in the event of the CD going into liquidation under IBC, a moratorium prevails which bars filing of suits, stay etc. against the CD during the period of moratorium.

Provided that the liquidator shall not sell the immovable and movable property or actionable claims of the corporate debtor in liquidation to any person who is not eligible to be a resolution applicant."

Clearly, the Code does not allow for such corporate action, i.e., merger or amalgamation, at the liquidation stage. However, the entire assets of the CD can be sold to an interested buyer by way of a slump sale. A specific provision should be included in IBC to facilitate amalgamation/merger both at resolution plan stage and during liquidation to fetch a better value for the stakeholders.

MORATORIUM ON ENFORCEMENT OF PERSONAL GUARANTEES

Upon admission of an application for CIRP or in the event of the CD going into liquidation under IBC, a moratorium prevails which bars filing of suits, stay etc. against the CD during the period of moratorium. Whether this moratorium also applies to the lender proceeding against the promoters or directors/ partners to enforce personal guarantees or collateral security provided by them can be a question that may require a specific provision in IBC. In the absence of such a provision, the parties will be governed by the provisions of Indian Contract Act, 1872, which could be inferred to mean that the lenders can proceed against such guarantors /collaterals if the lenders have already demanded payment and the CD has failed to pay. Chennai bench of NCLT has, in the matter of *V. Ramakrishnan vs. Veesons Energy Systems Pvt. Ltd.* and SBI restrained the financial creditor from selling the assets of the personal guarantor during the moratorium period on the reasoning that if this was allowed, the personal guarantor will step into the shoes of a creditor against the CD and thus, a charge would be created on the assets. However, this question still needs clarity.

CRIMINAL PROCEEDINGS UNDER SECTION 138

Another question that may arise is whether moratorium under Section 14 of IBC would apply in respect of criminal proceedings under Section 138 of Negotiable Instruments Act, 1881, against the signatories of dishonored cheque issued by CD. The answer to this question could be that the moratorium under IBC is only in respect of the suits against the CD (as distinguished from signatories to its cheques). Hence, in such cases, while proceedings against individuals under aforesaid Section 138 may continue, liability of the CD should be put on hold till the end of moratorium period. A clarificatory amendment would, however, be welcome.

More important question though is that after a resolution plan is approved or liquidation is announced, what would be the fate of these Section 138 cases. In the author's view, since the underlying liability itself is settled by force of law, such cases need to be compulsorily withdrawn, maybe with just financial penalties imposed on the signatories or Directors. But to allow these cases to continue would be a travesty of justice which needs to be rectified through an amendment to the Negotiable Instruments Act, 1881.

COMPLIANCE UNDER OTHER LAWS

Section 17(1) of IBC provides that from the date of appointment of RP or liquidator, the management of affairs of the CD shall vest in the RP or liquidator. Further, the powers of the board of directors or partners of the CD shall stand suspended and be exercised by the RP or liquidator. Does that mean that onus of compliance under other laws like labour laws, taxation laws, Companies Act, 2013 will fall on RP or liquidator? Obviously, duty and responsibility go hand in hand. If the Board of Directors is suspended and RP or liquidator is handling management of the affairs of the CD, the responsibility of compliance under various laws will squarely fall on RP or liquidator, which has also been clarified by IBBI by way of a circular. In case there is an accidental omission or non-compliance, can the authorities hold her liable for the same and initiate prosecution? Moreover, in a case where the CD has been non-functional for a few years and has not complied with the applicable laws, is the RP required to make all the compliance for those years as well?

SIGNING OF FINANCIAL STATEMENTS AND OTHER DOCUMENTS

Another tricky issue is the signing of documents (like financial statements) and returns under various laws. Where these documents require the signatures of a Managing Director, who should sign these papers when the Board of Directors is suspended and IP or liquidator is in charge of the management? IBC nowhere provides that the Code has overriding effect on the provisions of other laws in respect of such documents and returns. Suitable amendments need to be made under IBC as well as other laws to facilitate this, if indeed this is what is expected of RP or liquidator.

Additionally, IP or liquidator has to ensure that she is not held responsible for cascading effects of inaction or wrong decisions taken by earlier management which may require abundant caution on her part.

WITHDRAWAL OF APPLICATION BY OC

IBC does not make any provisions for withdrawal of application by the applicant. Once the application is admitted by AA, even if CD settles the dues of applicant OC, the proceedings would continue till a resolution plan is approved, failing which liquidation would be the outcome. When the dues have been settled, what kind of Resolution Plan is envisaged?

CHALLENGES OF RUNNING A BUSINESS

In some cases under CIRP, promoters and the existing management team do not cooperate with the RP. Besides, RP may not be familiar with the nature of business. In such a scenario, how is she expected to take commercial decisions and run business without a good knowledge of its business? Even if professionals are hired, they will take time to understand the business before they start performing. This may be specially challenging in case of a large, multi-locational company.

SUBSEQUENT DUES

IBC does not clearly spell out the treatment to be given to any dues arising subsequent to admission of application for CIRP by NCLT. It enjoins upon the Interim RP to collate claims of the creditors within 30 days of his appointment, place the details along with details of assets etc. before CoC. However, in the case of a supplier of goods or services, if the amount has not become due till the last date fixed for submission of such claims, there is no clear provision. For instance, in case of construction contracts, usually bills and payments are linked to physical progress of construction work. In case substantial work has been done by the contractor but it has not reached a stage where he can submit his bill, is he required to submit his claim on the basis of estimates? Similarly, a supplier's invoice may fall due months after the date of submission of claims. During CIRP, salaries to employees of the CD would continue to accrue. If the interim RP does not take such claims into account, the correct position may not get reflected in the statement to be placed before CoC. A clarification in the Code would therefore be in order.

IBC does not make any provisions for withdrawal of application by the applicant. Once the application is admitted by AA, even if CD settles the dues of applicant OC, the proceedings would continue till a resolution plan is approved, failing which liquidation would be the outcome. When the dues have been settled, what kind of Resolution Plan is envisaged?

DEPOSITS

In the case of a CD who has accepted unsecured deposits from a large number of depositors, it is not clear as to how those depositors will be accommodated in the CoC. In case of secured debentures and secured deposits, a trustee has to be appointed and such trustee will obviously represent the debenture-holders and depositors in the CoC. In case of unsecured deposits though, no such trustee is required to be appointed. More clarity is required with regard to such deposit holders.

CONCLUSION

The IBC is a historic legislation aimed at transforming the corporate landscape of India by facilitating quicker identification and resolution of financial stress. This law is still evolving and a lot still needs to be done. Also, finance providers and business community have to be educated to use this mechanism in appropriate cases to create an ecosystem where the inefficient businesses are either strengthened or allowed to be run by stronger managements. At this crucial juncture, we can ill-afford to allow the benefits of the Code being frittered away in needless litigation on trivial issues due to lack of clarity. An expeditious redressal of the issues raised in this article would go a long way in creating a vibrant insolvency resolution mechanism in the country. ■

The only place success comes before work is in the dictionary. - Vince Lombardi

Impact of GST on M&A

Source : The Chamber's Journal, March 2018

CA Prashant Deshpande, CA Gagan Agarwal
& CA Aditi Maheshwari

GST in M&A

Overview of GST

Introduction of Goods and Services Tax (GST) from 1st July, 2017 has overhauled the complex and multiple indirect taxes that were levied on different products, services and activities, across various stages of supply chain. GST has brought in efficiencies in business by reducing cascading effect of multiple taxes.

This paradigm shift in taxation in India has brought changes in almost all the business operations in the nation. The changes are not restricted at the transactional level but have also resulted in playing a major role in unleashing greater investment opportunities. The opportunities can be encashed either by way of a greenfield investment (i.e. investment by setting up new projects or entities) or a brownfield investment by way of acquiring other entities or businesses through mergers and acquisitions (M&A).

GST has a dual role to play here - while it has fostered M&A transactions, it also has some very specific implications on the M&A transactions. While the impact of GST on M&A transactions is discussed in detail in the subsequent paragraphs, let us first have a look at the key differences in the Indirect Tax regime pre and post GST.

Key Differences in the Indirect Tax Regime pre and post GST

Introduction of GST has played an instrumental role in changing the way business is done in India by bringing in more efficiencies. The key changes in the indirect taxation system as regards taxability due to the implementation of GST are mentioned below.

Indirect Taxes in India

In the erstwhile regime of indirect taxes in India, there were separate laws for separate activities. The erstwhile taxes along with their taxability under the GST law have been listed below:

Sr. No.	Tax	Taxable event	Levy by	GST levied by	Taxable event under GST
1	Customs Duty	Import	Centre	Centre	Import
2	Excise Duty	Manufacturing of goods	Centre	Centre and States	Taxable event is Supply under GST
3	Service Tax	Provision of service	Centre		
4	Central Sales Tax ('CST')	Inter-State sale	Centre		
5	Value Added Tax ('VAT')	Sale within State	State		

Tax Rates

In the indirect taxation system prevalent in India prior to 1st July 2017, tax was levied at each stage separately by the Centre and the State, at varying rates, on the full value of the goods. This led to multiple taxes being levied on the same commodity at different tax rates making tax administration cumbersome.

Under the GST regime, tax is be levied only on the value added at each stage. It is a single tax (collected at multiple points) with a full set-off available for the taxes paid earlier in the value chain.

Further, the Government has with the recommendation of the GST Council finalised four GST slab rates at 5%, 12%, 18% and 28% for different goods and services.

Under **0%** tax rate, essential commodities such as food grains, rice, and wheat are included. The first slab is **5%** tax rate, under which mass consumption products are included such as mustard oil, tea & spices. Processed food has been included in the **12%** slab rate. The third slab is **18%** tax rate, under which consumer goods have been included such as toothpaste, refrigerator & smartphones etc. Luxury items and other sin goods like cards, tobacco and aerated drinks have been kept in the **28%** tax slab rate. Most of the demerit goods are liable to GST cess over and above the existing rate of tax.

Further, it is pertinent to note that the Government is constantly pruning the list of goods and services under the 28% slab rates so as to ultimately reduce the burden of GST on end consumers.

Compliances under GST – Have they really become easier?

Type of Taxpayer	Compliances under earlier regime	Compliances under GST Regime	Increase or Decrease in Compliance Burden
Service provider providing services in multiple states	Option of centralised registration (i.e., 2 half yearly returns to be filed with monthly payments)	Registration and returns to be filed monthly in every State where services are provided (i.e. 3 returns every month along with monthly payment in every State	Increase
Manufacturers having factories in multiple states	Excise and sales tax registration and monthly returns in every state	Single registration and 3 monthly returns in every state	Increase
Trader	Sales Tax registration and monthly returns in every State	Single registration and 3 monthly returns in every State	Increase

As can be seen from above, for all the three class of taxpayers (i.e. service providers, manufacturers and traders), there is an increase in the compliance burden. Under GST, all the class of taxpayers are now required to file 3 monthly returns (i.e., GSTR-1 providing details of outward supplies, GSTR-2 providing details of all inward supplies and GSTR-3 is a consolidated return of outward and inward supplies). In addition to the said returns, a summary return in Form 3B is required to be filed every month and an Annual Return is required to be filed every year.

However, in November 2017, the GST Council announced that GSTR-2 and GSTR-3 returns are not required to be filed for the time being since the timelines to file those returns are being worked out by a separate committee. Further, in January 2018, it has been informed that a consolidated monthly return may be required to be filed by all types of taxpayers. The modalities are being worked out by the Council which is likely to be announced in due course of time.

Easing of tax burden and seamless flow of credit

The integration of tax laws in GST is expected to reduce the tax burden on the taxpayer. GST is a single tax (collected at multiple points) with a full set-off available for the taxes paid earlier in the value chain. Thus, the final consumer bears only the GST charged by the last dealer in the supply chain with set-off benefits at all the previous stages. This brings transparency and eliminates cascading.

Until 30th June, 2017, taxes on inter-state supply of goods accrued to the originating State. Thus, the taxes levied on inter-state supply was not available as credit to the receiver of goods, thus hindering the inter-state movement of goods. However, under GST, this situation is tackled by levying IGST, which accrues to the Centre and is then allocated by the Centre to the State where the goods/services are consumed.

Impact of GST in Mergers & Acquisitions

As GST has impacted structuring of various M&A transactions in India, it is essential to understand the implications of GST on the types of M&A transactions. Largely, the indirect tax implications of a transaction of transfer of business vary depending upon the manner in which the transaction is undertaken, as substantiated by the documentary evidences, intention and conduct of the parties to the transaction and facts & circumstances of each case.

GST implication on the sale/ transfer of securities

One of the most commonly resorted to methods of acquisition is by share acquisition. In this case, the ownership/ business of the Company is acquired by transfer of shares to the acquirer.

In the erstwhile tax regime, State VAT laws excluded securities from the definition of 'goods' and hence, securities were not liable to VAT. Contrary to this, service tax law had specifically included 'securities' under the definition of 'goods'. By considering them as goods, securities were kept outside the ambit of service tax. Accordingly, transfer of securities were not liable to either Service tax or VAT.

Under the GST law as well, securities have been specifically excluded from the definition of goods as well as services, thus ensuring no tax is levied on the sale of securities. This practice is in line with the global practices.

GST implication on Slump Sale

Under the erstwhile indirect tax regime, the implication of transfer of a business as a going concern including transfer of whole unit or a business division was not well-defined as most of the State VAT laws were silent on the applicability of VAT on the transfer of business. However, the Courts have consistently held that transfer of a business as a whole on a going concern basis would not be liable to sales tax or VAT since such sale cannot be equated to the sale of movable goods liable to sales tax or VAT. Moreover, the activity of transfer of business on a going concern basis had been specifically exempted under Entry 37 of Service Tax mega exemption Notification No. 25/2012 dated 20th June, 2012.

The position remains unchanged under the GST law as well. Sale of business on a going concern basis is not considered to be a supply in the course of business. Further, business does not qualify as goods under the GST law and hence GST cannot be levied upon the sale of business or an undertaking treating it as a supply of goods. In addition to the above, Notification No. 12/2017 Central Tax (Rate) dated 28th June 2017 specifically exempts services by way of transfer of a going concern as a whole or an independent part thereof. It is clear from the above that GST is not applicable on a slump sale transaction i.e., the transfer of business on a going concern basis.

GST implication on Itemised/ Piecemeal Sale

An itemised sale is the sale by way of transfer of specific assets and liabilities of a business by assigning a specific value to each item. This type of sale involves the disposal of key or selected business assets. Sale of separately identifiable and individually valued assets and liabilities was subject to the levy of VAT/ CST under the earlier indirect tax regime. The definition of goods included movable assets and intangibles including patents, trademarks, copyrights, etc. Nonetheless, the purchaser of the assets could avail input tax credit of VAT charged by the seller, subject to fulfilment of certain prescribed conditions.

Similarly, under the GST law as well, transaction of itemised/piecemeal sale is treated as a supply transaction, the rationale being that the individual assets being transferred are covered within the ambit of the definition of goods. Thus, GST is leviable on the transfer of business by way of itemised sale.

Historical Tax Liabilities

By virtue of the specific provision of VAT laws in various States, the historical tax liabilities and obligations of the business proposed to be transferred remain and travel with the business itself. These provisions made the acquirer, a party to liability or obligation of the transferor, by virtue of principle of joint and several liabilities.

Further, under the Central Excise and Service Tax Law, while the transferee was not jointly and severally liable for the tax liabilities of the transferor, however, by virtue of Section 11 of the Central Excise Act, 1944 and Section 87 of the Finance Act, 1994, where any duty / tax was recoverable from the transferor and the business was transferred, such duty / tax could be recovered by attaching the goods in custody or possession of the transferee.

The provisions in the GST law have been aligned to the erstwhile VAT laws i.e., joint and several responsibility of the transferor and transferee in case of historical liability (whether determined prior to the transfer of business or thereafter) of the business transferred as per Section 85 of the Central GST law. This indicates that statutorily, the buyer will be equally liable as the seller and hence, it will be extremely essential for the buyer to be aware about the quantum of tax exposure/ liabilities being inherited along with the business.

Personal liability of directors

Under the erstwhile service tax law, in case of evasion of service tax or other specified offences under section 78A of the Finance Act, 1994, any director and other officers in charge of, and responsible to the Company for the conduct of business and knowingly concerned with the contravention were liable to penalty up to INR 1 lakh. In addition, for the above offences exceeding specified monetary threshold (INR 200 lakhs), there was a provision for punishment by way of imprisonment between six months to seven years.

There are significant changes brought in the GST law as regards personal liability of the directors. Section 89 of the GST law provides that if any tax, interest or penalty cannot be recovered from a private company, it can be recovered jointly and severally from the directors of the company during the period of liability, unless directors can prove that there is no gross neglect on their part. Further, Section 137 provides that in case of offences by companies, every person in charge of, and responsible to the Company for the conduct of business of the Company as well as the Company shall be punished. Further, as per Section 132, for specified offences, there is a provision for punishment by way of imprisonment between six months to five years depending on the quantum of offence.

As can be seen from above, the provisions in GST as regards the personal liability of director are far more stringent than any other law subsumed under GST.

Unutilised Tax Credit

Unutilised tax credit means the amount of tax credit (pertaining to the transferred business) claimed but remaining unutilized in the hands of transferor at the time of business transfer.

Most of the State VAT laws had specific provisions that allowed transfer of VAT credit to the buyer of the business. Similarly, the CENVAT Credit Rules, 2004 also permitted transfer of unutilised CENVAT credit to the transferee in case of transfer of business. However, for transferring of CENVAT credit, it was mandatory to transfer the liabilities of the business and also the inputs and capital goods on which such credit is taken.

Section 18(3) of the GST law also permits transfer of unutilised GST credit to the transferor in the case of transfer of a business. Also, similar to the erstwhile regime, the transfer of credit is subject to the condition that the liability of the business are also transferred along with the assets. Further, Rule 41 of the GST Rules prescribes Form ITC-02 which is required to be submitted by the transferor furnishing complete details of sale, merger, demerger, amalgamation, etc., along with the details of unutilised input tax credit lying in the hands to the transferee. The transferee is required to accept the details so furnished by the transferor on the common GST portal.

Inter-Company transactions during intervening period

Intervening period refers to the period between the appointed date (i.e., date from which business of the transferor vests with the transferee) and the effective date (i.e. when the Court order is submitted to the Registrar of Companies, in cases involving transfer of business through a Court scheme).

Technically, in case of an amalgamation or merger with retrospective effect, two companies should be considered as a single entity from the appointed date and thus any transaction of goods and services between the appointed date and effective date should be considered as transaction with oneself.

However, in the erstwhile tax (service tax) regime where there was no specific provision in the law prescribing the leviability of service tax in specific situations of provision of services between the transferor and transferee during the intervening period. Based on various decisions by the Court, taxpayers adopted a position that transactions between the transferor and transferee during the intervening period should be considered as transactions between the same entities and hence not liable to service tax. Further, the VAT implication on a sale transaction between the transferor and transferee during the intervening period varied from State to State. VAT laws of many States had a specific provision wherein the transferor and transferee are treated as separate entities till the effective date and hence, subjected to VAT.

The inconsistency between VAT laws and service tax law in this matter has been put to rest under GST. According to Section 87 of the GST law, two or more companies are treated as distinct companies up to the date of the court order, implying that the transactions between them during the intervening period are liable to GST.

Conclusion

Though the position for most of the aspects remain unchanged, the GST law has majorly addressed most of the concerns of the M&A transactions thus bringing in greater clarity on the taxability of business transfer from an indirect tax perspective.

Amendments to Ind AS

Source : KPMG

KPMG

IFRS Notes

MCA issues amendments to Ind AS effective 1 April 2018

10 April 2018

KPMG.com/in

Introduction

The Ministry of Corporate Affairs (MCA), on 28 March 2018, issued certain amendments to Ind AS. These amendments maintain convergence with IFRS by incorporating amendments issued by International Accounting Standards Board (IASB) into Ind AS.

The IASB along with the IFRS Interpretations Committee, issues amendments to IFRS either as part of its annual improvement process or as specific amendments to IFRS, to resolve inconsistencies in the standards or to provide further clarifications.

The amendments relate to the following standards:

- Ind AS 40, *Investment Property*
- Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*
- *Ind AS 12, Income Taxes*
- Ind AS 28, *Investments in Associates and Joint Ventures*
- Ind AS 112, *Disclosure of Interests in Other Entities*

This issue of IFRS Notes provides an overview of the amendments issued by MCA.

Overview of amendments

Ind AS 40, *Investment Property*

The amendment lays down the principle regarding when a company should transfer asset to, or from, investment property. However, it was not clear whether the evidence of a change in use should be the one specifically provided in the standard.

Accordingly, the amendment clarifies that a transfer is made when and only when:

a) There is an actual change of use i.e. an asset meets or ceases to meet the definition of investment property

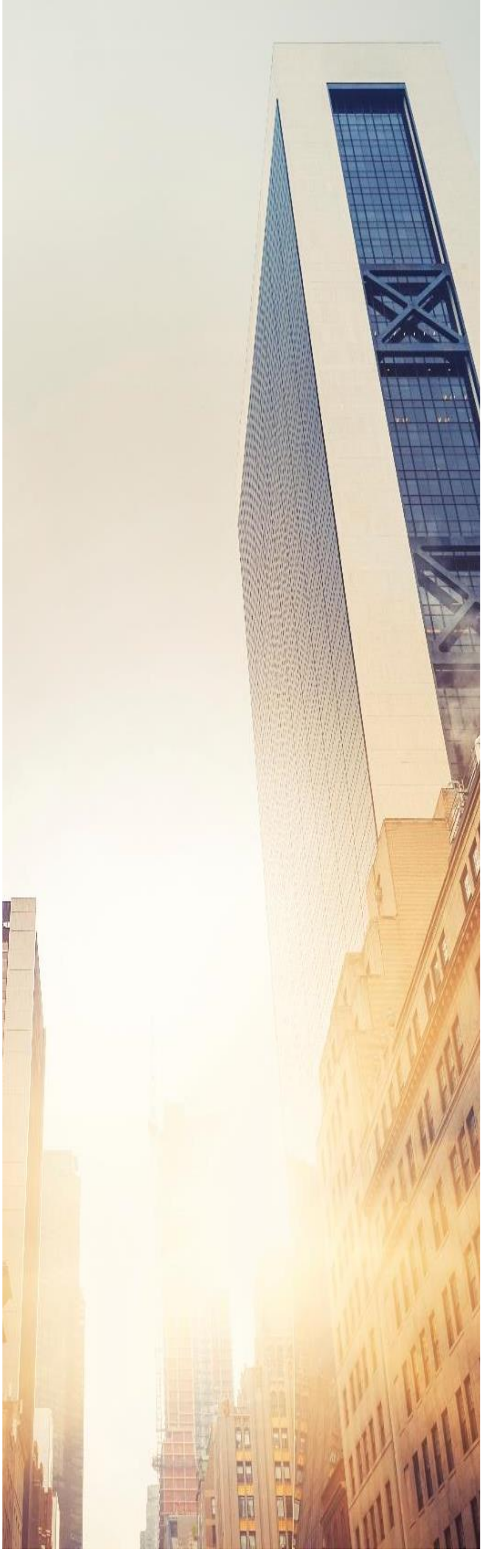
b) There is evidence of the change in use.

Applying this principle, an entity would transfer property under construction or development to, or from investment property when and only when there is a change in the use of such property, supported by evidence.

Additionally, the amendment re-characterises the list of circumstances (evidence) as a non-exhaustive list of examples to be consistent with the principle described above.

The examples of evidence in this case may include factors such as commencement or end of owner occupation, commencement of development with a view to sale or inception of an operating lease to another party.

A change in management's intentions for the use of a property does not provide evidence of a change in use.



Overview of amendments (cont.)

Effective date: The amendments are applicable for annual periods beginning on or after 1 April 2018.

Transitional provisions

A company has a choice on transition to apply:

- *Prospective approach:* Apply the amendments to transfers that occur after the date of initial application and also reassess the classification of property assets held at that date; or
- *Retrospective approach:* Apply the amendments retrospectively, but only if it does not involve the use of hindsight.

Ind AS 21, *The Effects of Changes in Foreign Exchange Rates*

Under current Ind AS, foreign currency transactions are recorded in the company's functional currency by applying the spot exchange rate on the date of the transaction – i.e. on the date when the transaction first qualifies for recognition.

However, when foreign currency consideration is paid or received in advance of the item it relates to which may be an asset, an expense or income – Ind AS 21 is not clear on how to determine the date of the transaction. To address this issue, the IFRS Interpretations Committee has issued an IFRIC 22, *Foreign Currency Transactions and Advance Consideration* which has been incorporated as Appendix B to Ind AS 21.

The Appendix B would apply when a company:

- Pays or receives consideration denominated or priced in a foreign currency, and
- Recognises a non-monetary prepayment asset or deferred income liability – e.g. non-refundable advance consideration before recognising the related item at a later date.

Establishing the date of the transaction

The date of the transaction which is required to determine the spot exchange rate for translation would be the earlier of:

- the date of initial recognition of the non-monetary prepayment asset or deferred income liability, and
- the date that the related item is recognised in the financial statements.

If the transaction is recognised in stages, then a transaction date would be established for each stage. The spot exchange rate for each date would be applied to translate each part of the transaction.

Effective date: The appendix is applicable for accounting periods beginning on or after 1 April 2018 (retrospective application is permitted).

Transitional provisions

On initial application, an entity should apply Appendix B either:

- Retrospectively, or
- Prospectively to all assets, expenses and income in the scope of the Appendix initially recognised on or after:
    i. the beginning of the reporting period in which the entity first applies the Appendix, or
    ii. the beginning of a prior reporting period presented as comparative information in the financial statements of the reporting period in which the entity first applies the Appendix.

In case of prospective application, an entity should apply the Appendix to assets, expenses and income initially recognised on or after the beginning of the reporting period (provided in (i) or (ii) above) for which non-monetary assets or non-monetary liabilities, arising from advance consideration, have been recognised before that date.

Overview of amendments (cont.)

Ind AS 12, *Income Taxes*

Ind AS 12 specify that a difference between the carrying amount of an asset measured at fair value and its higher tax base gives rise to a deductible temporary difference. This is because the calculation of a temporary difference in Ind AS 12 is based on the premise that the entity will recover the carrying amount of an asset, and hence economic benefits will flow to the entity in future periods to the extent of the asset's carrying amount at the end of the reporting period.

Consequently, decreases below cost in the carrying amount of a fixed-rate debt instrument measured at fair value for which the tax base remains at cost give rise to a deductible temporary difference. This applies irrespective of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use, i.e. continuing to hold it, or whether it is probable that the issuer will pay all the contractual cash flows.

The amendments explain that determining temporary differences and estimating probable future taxable profit against which deductible temporary differences are assessed for utilisation are two separate steps and the carrying amount of an asset is relevant only to determining temporary differences. The carrying amount of an asset does not limit the estimation of probable future taxable profit. In its estimate of probable future taxable profit, an entity includes the probable inflow of taxable economic benefits that results from recovering an asset. This probable inflow of taxable economic benefits may exceed the carrying amount of the asset.

The amendments considers that:

- Tax law determines which deductions are offset against taxable income in determining taxable profits.
- No deferred tax asset is recognised if the reversal of the deductible temporary difference will not lead to tax deductions.

Consequently, if tax law offsets a deduction against taxable income on an entity basis, without segregating deductions from different sources, an entity carries out a combined assessment of all its deductible temporary differences relating to the same taxation authority and the same taxable entity. . However, if tax law offsets specific types of losses only against a particular type, or types, of income (for example, if tax law limits the offset of capital losses to capital gains), an entity assesses a deductible temporary difference in combination with other deductible temporary differences of that type(s), but separately from other deductible temporary differences. Segregating deductible temporary differences in accordance with tax law and assessing them on such a basis is necessary to determine whether taxable profits are sufficient to utilise deductible temporary differences.

Effective date: The amendments are applicable retrospectively for annual periods beginning on or after 1 April 2018.

Transition relief

On initial application, an entity may recognise the change in the opening equity of the earliest comparative period in opening retained earnings without allocating the change between opening retained earnings and other components of equity. The entity should disclose the fact if it applies the transitional relief.

Ind AS 28, *Investments in Associates and Joint Ventures*

When an investment in an associate or joint venture is held by, or is held indirectly through, a venture capital organisation, or a mutual fund, unit trust and similar entities including investment-linked insurance funds, the entity may elect, in accordance with Ind AS 28, to measure that investment at fair value through profit or loss. However, it was not clear whether the entity is able to choose between applying the equity method or measuring the investment at fair value for each investment, or whether instead the entity applies the same accounting to all of its investments in associates and joint ventures.

Accordingly, Ind AS 28 has been amended to clarify that a venture capital organisation, or a mutual fund, unit trust and similar entities may elect, at initial recognition, to measure investments in an associate or joint venture at fair value through profit or loss separately for each associate or joint venture.

Overview of amendments (cont.)

In addition, Ind AS 28 permits an entity that is not an investment entity to retain the fair value measurement applied by its associates and joint ventures (that are investment entities) when applying the equity method. Therefore, this choice is available, at initial recognition, for each investment entity associate or joint venture.

Effective date: The amendments are applicable retrospectively for annual periods beginning on or after 1 April 2018.

Ind AS 112, *Disclosure of Interests in Other Entities*

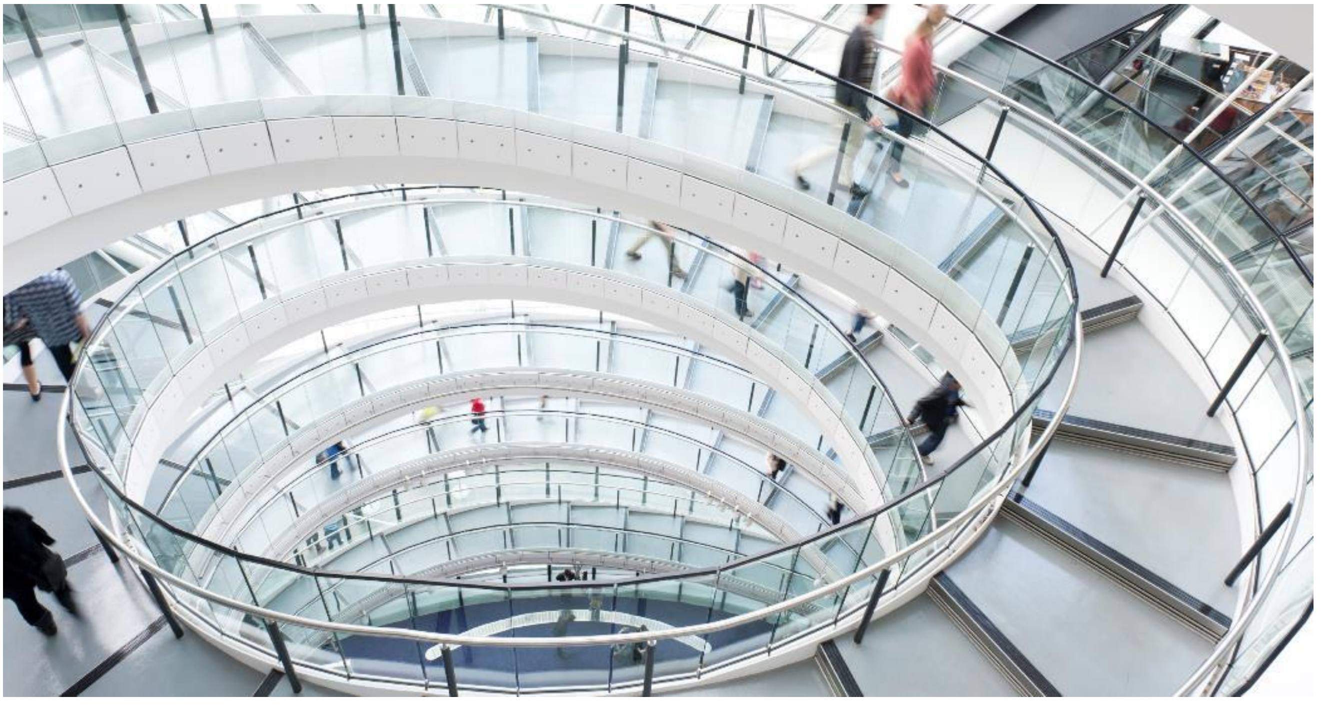
The amendments clarify that disclosure requirements for interests in other entities also apply to interests that are classified (or included in a disposal group that is classified) as held for sale or as discontinued operations in accordance with Ind AS 105, *Non-current Assets Held for Sale and Discontinued Operations*.

Effective date: The amendments are applicable retrospectively for annual periods beginning on or after 1 April 2018.

Our comments

The amendments issued with reference to Ind AS are in line with the IFRS amendments to improve the practical application of these standards. The amendments are effective for annual period beginning on or after 1 April 2018. However, some of the amendments are mandatorily required to be applied on a retrospective basis whereas others provide an option to adopt retrospectively.

The entities in India that are required to comply with Ind AS should make a note of these amendments and accordingly consider the information that would be required to be in compliance with these amendments.



Restrictions on 2-tier subsidiaries

Source : The Chamber's Journal, March 2018

CA Sanjeev Shah & CS Abdullah Fakih

Restrictions on 2-tier subsidiaries – A mixed bag!

This article deals with the restrictions on having multi-layered subsidiary companies under the Companies Act, 2013, exemptions available to certain classes of companies, practical challenges that may be faced due to the restrictions and expected impact on future M&As.

Background

The Companies Act, 2013 (2013 Act) was enacted with the aim to facilitate more business-friendly corporate regulations, improve corporate governance norms, enhance accountability on the part of corporates and auditors, raise levels of transparency and protect the interests of investors, particularly small investors. The 2013 Act enhances self-regulation, encourages corporate democracy and virtually eliminates matters requiring Government approvals.

One of the objectives of the 2013 Act is to prevent money laundering. With this objective in mind, restrictions have been imposed on companies' ability to set-up multi-layer subsidiaries and investment companies.

Section 186(1) of the 2013 Act states that investments cannot be made through more than two layers of investment companies, subject to the following exceptions:

- Where a company acquires any other company incorporated in a country outside India if such other company has investment subsidiaries beyond two layers as per the laws of such country;
- A subsidiary company may have any investment subsidiary for the purposes of meeting the requirements under any law for the time being in force.

The explanation to section 186(1) states that the expression "investment company" means a company whose principal business is the acquisition of shares, debentures or other securities.

Section 186(1) of the 2013 Act was notified with effect from 1st April, 2014.

Section 2(87) of the 2013 Act, defines "subsidiary company". The *proviso* to the definition prohibits prescribed class or classes of "holding companies" from having layers of subsidiaries beyond prescribed numbers. As per the explanation (d) to section 2(87) "layer" in relation to a holding company means its subsidiary or subsidiaries. The said *proviso* was notified to be effective from 20th September 2017.

Companies Law Committee Report

On multi-layer subsidiaries

Companies Law Committee (CLC) noted that the limit on having layers of subsidiaries beyond the prescribed numbers were included in the 2013 Act to address practices of creating subsidiaries aimed at making it difficult to trace the source of funds and their ultimate use, and reduce the usage of multiple layers of structuring for siphoning off funds. The said provisions were incorporated in the wake of various reported scams. In this regard, CLC also noted that the J. J. Irani Committee Report on Company Law recommended that the new Companies Act should not impose severe restrictions on corporate structuring, as these prescriptions would put Indian companies at a disadvantage *vis-à-vis* their international counterparts. The report stated, "*therefore, we are of the view that there may not be any restriction to a company having any number of subsidiaries, or to such subsidiaries having further subsidiaries.*" The J. J. Irani Committee Report also noted that *proper disclosures accompanied by mandatory consolidation of financial statements should address the concern attendant to the lack of transparency in holding-subsidiary structure.* The J. J. Irani Committee Report had also recognised that siphoning off of funds could take place through other routes, and therefore, imposing a blanket restriction on the number of layers of subsidiaries may not be the best way to deal with the concern.

A perusal of the Parliamentary Standing Committee Report on the Companies Bill, 2012 (Standing Committee Report) also reveals that stakeholders had represented before the Committee that imposing restrictions on layers could be construed as restrictive for conduct of businesses. In addition, at another place in the Standing Committee Report, it was proposed to introduce a register of beneficial owners of a company, which would address the need to know the ultimate beneficial owners in complex corporate structures.

The CLC, therefore, felt that the *proviso* to Section 2(87) was likely to have a substantial bearing on the functioning, structuring and the ability of companies to raise funds and hence recommended that the said proviso be omitted from the 2013 Act.

On multi-layer investment companies

CLC observed that the layering restrictions on investment companies under Section 186(1) may become too obtrusive and impractical in the modern business world. Regulatory concerns arising out of earlier scams were also noted. CLC noted that while companies that became a subsidiary of another investment company due to any corporate action such as the non-subscription of a rights issue from the layering requirements, etc. could be exempted, it would not address the core issue that there may be several legitimate business justifications for use of a multi-layered structure, and such restriction hampers the ability of a company to structure its business. CLC felt that sufficient safeguards have been built into the oversight mechanism of SEBI and stock exchanges, and the recommendations on beneficial ownership register requirements should dispel regulatory concerns.

Accordingly, in line with the above recommendations of CLC, the Companies (Amendment) Bill, 2016 had proposed to omit the restrictions on number of layers of subsidiaries as well as restrictions on having more than two-layers of investment companies.

Subsequently, in view of media reports of misuse of multiple layers of companies, where shell companies are created for diversion of funds for money laundering, the Government decided, in June 2017, to retain these provisions and placed a draft notification of the rules to be prescribed under section 2(87) for public comments.

After receiving comments from the public, MCA has, on 20th September 2017, notified the proviso to section 2(87) as well as issued the Companies (Restriction on Number of Layers) Rules, 2017 (the Rules).

The Rules prescribe companies not to have more than two layers of subsidiaries, subject to certain exceptions.

Salient features of the Rules

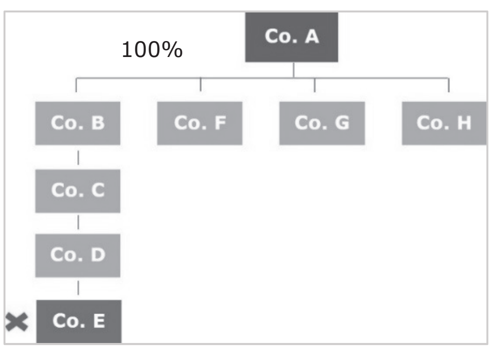
On and from 20th September 2017, no company shall have more than two layers of subsidiaries. However, the following are exceptions to this rule:

- A company may acquire a company incorporated outside India with subsidiaries beyond two layers as per the local laws of such country.

  It may be noted that above excludes only "acquisition" of existing companies outside India and does not talk about setting-up a newly-incorporated entity as a subsidiary outside India.

- In computing the number of layers, one layer which consists of one or more wholly-owned subsidiary (WOS) or subsidiaries shall not be taken into account.

Illustration:



If Co. A is the holding company, it can have one WOS (Co. B) or subsidiaries (Co. F, Co. G and Co. H). Co. B in turn can have up to two-step-down subsidiaries or layers of subsidiaries i.e. Co. C and Co. D. However, Co. D cannot have any subsidiary (Co. E). There is no restriction on Co. B having fellow subsidiaries which are directly held by Co. A, i.e. Co. F, Co. G, Co. H and so on. Similarly Co. F, Co. G and Co. H may have up to two layers of step-down subsidiaries.

- The following classes of holding companies are exempted from the applicability of the Rules:
  - Banking companies
  - Systemically Important Non-Banking Financial Companies (NBFC-SI) registered with the Reserve Bank of India
  - Insurance companies
  - Government companies

It may be observed that no exemptions have been given under the Rules to Housing Finance Companies, Core Investment Companies (CICs) which are not systemically important.

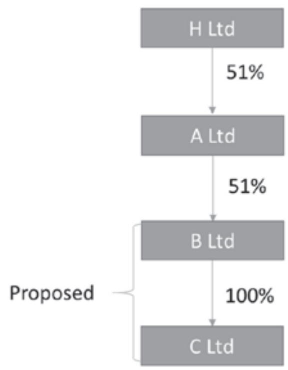
- Existing companies having more than two-layers of subsidiaries as on 20th September 2017 are required to ensure the following:
  - File a return in the prescribed form with the Registrar of Companies within 150 days of 20th September 2017;
  - Shall not have any additional layer of subsidiaries over and above the existing layers on or after 20 September 2017; and
  - In case one or more layers of subsidiaries are reduced by such companies subsequent to the Rules being notified, the number of layers permissible shall not be more than:-
  - Number of layers after such reduction; or
  - Two layers;

  whichever is more.

It is pertinent to note that the existing restrictions under section 186(1) of the 2013 Act from making investment companies through not more than two layers of investment companies would continue to apply and there is no change in the same after introduction of the Rules.

Exemption of WOS – at which layer?

A question could arise whether the exemption of not counting WOS can be at a layer not immediately following the layer of the holding company. This is explained in below illustration:



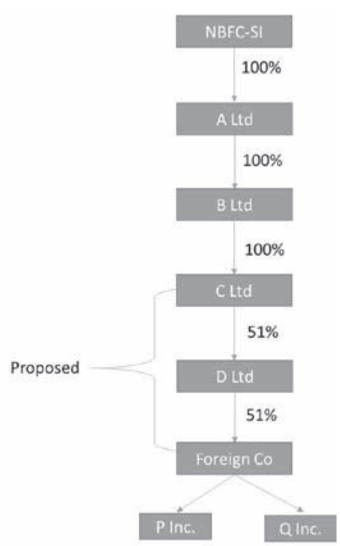
H Ltd. has a subsidiary A Ltd. which in turn has a subsidiary B Ltd. Now B Ltd. proposes to form a WOS, C Ltd. Can H Ltd. avail the exemption for the layer represented by C Ltd.?

Since C Ltd. will not be treated as WOS of H Ltd., H Ltd. cannot avail the exemption, and in fact, B Ltd. cannot form / acquire C Ltd.

Some practical challenges

In light of the Rules, let us examine the workability of certain structures:

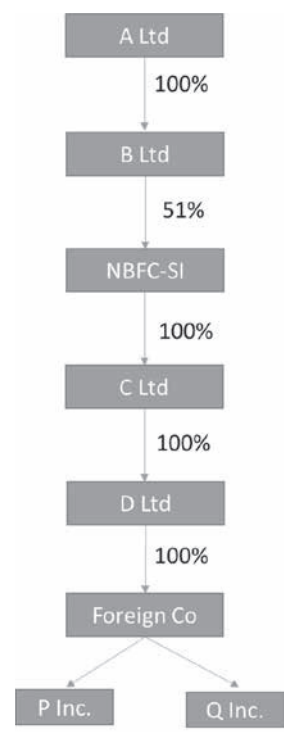
Case 1



Question: An NBFC-SI has a WOS viz., A Ltd. which in turn has B Ltd. as its WOS. B Ltd. has a WOS C Ltd. C Ltd. desires to incorporate a subsidiary D Ltd. which would acquire a Foreign Co. Is the incorporation of D Ltd. and acquisition of existing Foreign Co. (which already has subsidiaries abroad) allowed under the Rules?

Response: NBFC-SI is exempt from the Rules, i.e., there is no limit on the number of layers of subsidiaries it can incorporate. However, the rule also needs to be examined at the level of A Ltd. Since one layer of WOS is exempt, investment of A Ltd. in B Ltd. would be exempt from the two-layer rules. Further, B Ltd.'s investment into C Ltd. will be regarded as one layer of subsidiary for A Ltd. Further, setting up of D Ltd. by C Ltd. would be possible as it will result into just two layers. The question would be whether D Ltd. can acquire Foreign Co.? In light of specific conditional exemption given to companies incorporated outside India, it is possible to incorporate D Ltd. and acquire Foreign company under D Ltd.

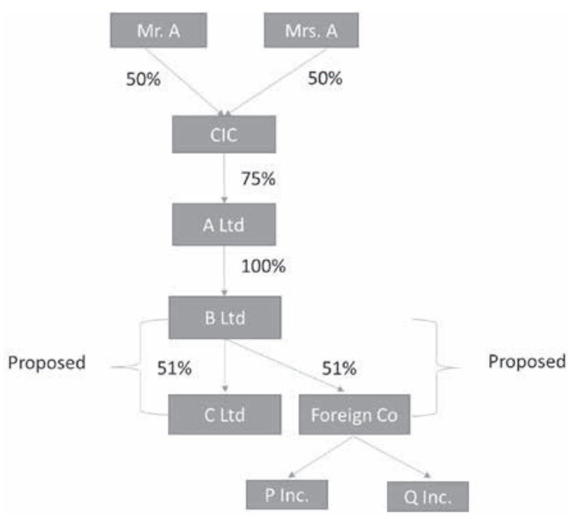
Case 2



Question: A Ltd. is an existing company and proposes to incorporate companies as shown above. The question is till which layer will investment be permitted under the Rules?

Response: For A Ltd., investment in B Ltd. would be not be reckoned for one layer as it is a WOS. B Ltd. can form NBFC-SI (1st layer counted for A Ltd.) and NBFC-SI can have C Ltd. (2nd layer counted for A Ltd.). Now even if NBFC-SI is permitted to have any layers of subsidiaries, since, A Ltd. has exhausted 2 layers, incorporation of D Ltd. by C Ltd. would not be permissible as it would end up in A Ltd. having three layers of subsidiaries. Subsequently, the question of D Ltd. acquiring Foreign co. does not arise.

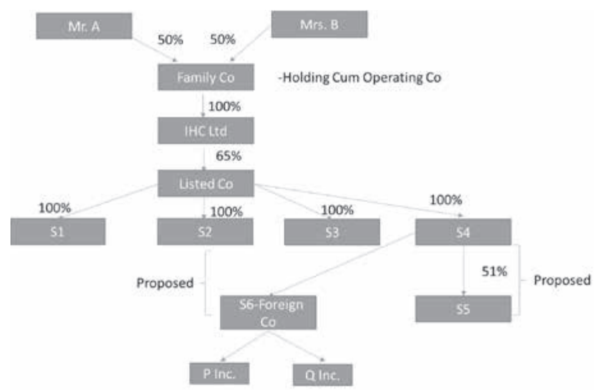
Case 3



Question: Husband and wife, Mr. A and Mrs. A hold 50% each in CIC (exempt from registration with RBI). CIC has a subsidiary A Ltd. which in turn has a WOS B Ltd. B Ltd. now proposes to acquire C Ltd. and a Foreign Co. Is the incorporation of C Ltd. and Foreign Co. permitted under the Rules?

Response: CIC does not have any WOS. Further, CIC does not enjoy exemption from having any layers of subsidiaries since CIC is not registered with RBI. Hence, for CIC, investment up to two layers, i.e. up to B Ltd. is permissible. Incorporation / acquisition of C Ltd. is not permitted. However, acquisition of Foreign Co. would be permissible, in light of specific conditional exemption given to companies incorporated outside India.

Case 4



Given the above structure, can S4 have step down subsidiary in S5 and S6?

Response: Investment in IHC Ltd. will be exempt as one layer of WOS for Family Co. Further, investments by IHC Ltd. in Listed Co. and further investments by Listed Co. into S1, S2, S3 and S4 is permissible as it is within two layers. The proposed investment by S4 in S5 will not be permissible as it would result into 3rd layer of subsidiary for Family Co. However, investment by S4 in S6-Foreign Co. would be possible in light of specific conditional exemption given to companies incorporated outside India. So Listed Co. will be impacted for further growth through layers below S4 in India due to its ultimate parent (Family Co.) already exhausting the limit of two layers.

Future M&A activities impacted by two layer rule

M&A transactions typically involve creation of subsidiaries and the Rules are expected to throw a spanner into the works when it comes to use of multi-layered entities for M&A.

It is also important to see all layers of subsidiaries in the target entity (third party) by the acquirer during the due diligence process, if transaction (acquisition / takeover / amalgamation etc.) of target entity would result into the acquirer ending up having more than two layers of subsidiaries post consummation of the transaction.

The Rules would also pose challenges when it comes to certain industry sectors, viz., infrastructure, real estate etc. where creation of Special Purpose Vehicles (SPVs) and multi-layered structures is a common practice to ring fence the holding company from any liabilities that may arise due to failure of any project or to meet statutory requirements or to attract a project-specific investor.

Further, any scheme of arrangement giving rise to more than two layers of subsidiaries would pose a challenge in getting approval of the National Company Law Tribunal (NCLT), as the NCLT does not have powers to approve a scheme by disregarding the express prohibition under the proviso to section 2(87) read with the Rules.

Penalty for non-compliance

- In case of contravention of the Rules, the company and every officer of the company who is in default is punishable with fine up to ₹ 10,000 and in case of continuing default, with a further fine up to ₹ 1,000 per day of default.
- There is no penalty prescribed for contravention of section 2(87) of the Companies Act, 2013. Hence, in the event of a contravention, it will attract the provisions of section 450 of the Companies Act, 2013 which states that the company and every officer of the company who is in default will be punishable with fine up to ₹ 10,000 and in case of a continuing default, with a further fine up to ₹ 1,000 per day of default.
- In case a company contravenes the provisions of section 186, the company shall be punishable with fine which shall be at least ₹ 25,000 but which may extend to ₹ 5,00,000 and every officer of the company who is in default shall be punishable with imprisonment for a term up to 2 years and with fine which shall be at least ₹ 25,000 but may extend up to ₹ 1,00,000.

Conclusion

Thanks to the grand-fathering provisions under the Rules, corporate structures existing on 20 September 2017 would not have to be dismantled. However, any new structure envisaged on or after 20th September, 2017 will have to comply with the Rules.

The cap on layers of subsidiaries is expected to keep a check on usage of multiple layers of holding-subsidiary structures for siphoning off / routing of funds. The Rules may pose significant challenges in M&A activities especially when it comes to inorganic growth, as companies will have to structure the acquisitions accordingly, which may have implications under tax and other regulations.

Source

1. *Notification G.S.R. 1176(E) and Notification S.O. 3086(E) dated 20 September, 2017 issued by MCA*
2. *Report of the Companies Law Committee issued in February, 2016.*

Leveraged Buyout – A new form of funding

Source : ICSI Chartered Secretary, April 2018

ARTICLE

Leveraged Buyout Analysis: A New Form of Funding

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A leveraged buyout (LBO) is an acquisition of a company or a segment of a company funded mostly with debt. A financial buyer (e.g. private equity fund) invests a small amount of equity (relative to the total purchase price) and uses leverage (debt or other non-equity sources of financing) to fund the remainder of the consideration paid to the seller. LBO analysis generally provides a "floor" valuation for the company, and is useful in determining what a financial sponsor can afford to pay for the target and still realize an adequate return on its investment.

The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital. In leveraged buy-outs usually there is 90% debt and 10% equity. Because of this high debt-equity ratio, the bonds usually are not investment grade and are referred to as junk bonds. Leveraged buyouts have had a notorious history, especially in the 1980s when several prominent buyouts led to the eventual bankruptcy of the acquired companies. This was mainly due to the fact that the leverage ratio was nearly 100% and the interest payments were so large that the company's operating cash flows were unable to meet the obligation.

Private Equity Analysts and Associates can expect to build leveraged buyout models in excel on a day-to-day basis at middle market and large private equity firms. Whether you are modeling out how much debt you can take on to acquire a commercial building or checking the feasibility of acquiring a public company with a significant amount of debt, you will need to understand how to put together a typical LBO model from scratch.

A simple LBO model includes the following:

1. Transaction Assumptions tab that includes Sources & Uses and Transaction Assumptions sections.
2. Integrated Financial Statements tab that includes an integrated Income Statement, Balance Sheet and Cash Flow section with historical and projected forecasts three to five years post-closing.
3. Debt Schedule tab which shows debt prior to acquisition, the adjustments, and projected debt schedule post-closing.
4. Returns Analysis tab that includes an IRR calculation.

TRANSACTION STRUCTURE

Given below is a simple diagram of an LBO structure. The new investors (e.g. LBO firm or management of the target) form a new corporation for the purpose of acquiring the target. The target becomes a subsidiary of the new company, or the new company and the target can merge.

APPLICATIONS OF THE LBO ANALYSIS

Determine the maximum purchase price for a business that can be paid based on certain leverage (debt) levels and equity return parameters.

Develop a view of the leverage and equity characteristics of a leveraged transaction at a given price.

Calculate the minimum valuation for a company since, in the absence of strategic buyers, an LBO firm should be a willing buyer at a price that delivers an expected equity return that meets the firm's *hurdle rate*.

STEPS IN THE LBO ANALYSIS

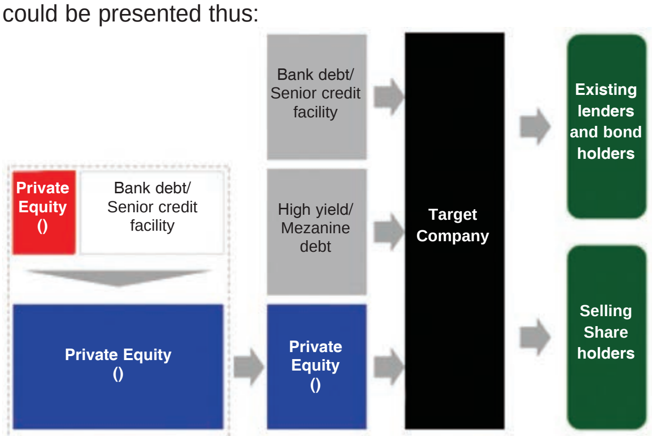
Develop operating assumptions and projections for the standalone company to arrive at EBITDA and cash flow available for debt repayment over the investment horizon (typically 3 to 7 years).
Determine key leverage levels and capital structure (senior and subordinated debt, mezzanine financing, etc.) that result in realistic financial coverage and credit statistics.

Estimate the multiple at which the sponsor is expected to exit the investment (should generally be similar to the entry multiple).

Calculate equity returns (IRRs) to the financial sponsor and sensitize the results to a range of leverage and exit multiples, as well as investment horizons.

Solve for the price that can be paid to meet the above parameters (alternatively, if the price is fixed, solve for achievable returns).

The basic structure of a generic leveraged buyout transaction could be presented thus:



RETURNS

In LBO transactions, financial buyers seek to generate high returns on the equity investments and use financial leverage (debt) to increase these potential returns. Financial buyers evaluate investment opportunities by analyzing expected *internal rates of return* (IRRs), which measures the returns on invested equity. IRRs represent the discount rate at which the net present value of cash flows equals zero. Historically, financial sponsors' hurdle rates (minimum required IRRs) have been in excess of 30%, but may be as low as 15-20% for particular deals under adverse economic conditions. Hurdle rates for larger deals tend to be a bit lower than the hurdle rates for smaller deals.

Sponsors also measure the success of an LBO investment using a metric called "cash-on-cash" (CoC). CoC is calculated as the final value of the equity investment at exit divided by the initial equity investment, and is expressed as a multiple. Typical LBO investments return 2.0 x - 5.0 x cash-on-cash. If an investment returns 2.0 x CoC, for example, the sponsor is said to have "doubled its money".
The returns in an LBO are driven by the following three factors:
- De-levering (paying down debt)
- Operational improvement (e.g. margin expansion, revenue growth)
- Multiple expansion (buying low and selling high)

RISK

Equity holders – In addition to the operating risk, assumed risk arises due to significant financial leverage. Interest costs resulting from substantial amounts of debt are "fixed costs" that can force a company to default if not paid. Furthermore, small changes in the enterprise value (EV) of a company can have a magnified effect on the equity value when the company is highly levered and the value of the debt remains constant.
Debt holders – The debt holders bear the risk of default equated with higher leverage as well, but since they have the most senior claims on the assets of the company, they are likely to realize a partial, if not full, return on their investments, even in bankruptcy.

EXIT STRATEGIES

Ideally, an exit strategy enables financial buyers to realize gains on their investments. Exit strategies most commonly include an outright sale of the company to a strategic buyer or another financial sponsor, an IPO, or a recapitalization. A financial buyer typically expects to realize a return on its LBO investment within 3 to 7 years *via* one of these strategies.

EXIT MULTIPLES

The value of a company acquired in an LBO transaction is often valued at the time of acquisition using valuation multiples (e.g. EV/EBITDA). While exiting the investment at a multiple higher than the acquisition multiple will help boost a sponsor's IRR, it is difficult to justify a prediction that the exit multiple will be higher than the entry multiple (known as "multiple expansion"). It is important that exit assumptions reflect realistic approaches and multiples (exit multiples should generally equal acquisition multiples) for analytical purposes, and multiple expansion is usually an unjustifiable assumption.

Issues to Consider in an LBO Transaction

Industry characteristics:

- Type of industry
- Competitive landscape
- Cyclicality
- Major industry drivers
- Potential outside factors (politics, changing laws and regulations, etc.)

Company-specific characteristics:

- Strategic positioning within the industry (market share)
- Growth opportunity
- Operating leverage
- Sustainability of operating margins
- Potential for margin improvement
- Level of maintenance CapEx vs. growth CapEx
- Working capital requirements
- Minimum cash required to run the business
- Ability of management to operate effectively in a highly levered situation

Market conditions:

- Accessibility and cost of bank and high yield debt
- Expected equity returns

Exhibit 1 – LBO Structure

Assumptions	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Sales Growth	5.0%	5.0%	5.0%	5.0%	5.0%
COGS as % of Sales	60.0%	60.0%	60.0%	60.0%	60.0%
S,G&A as % of Sales	15.0%	15.0%	15.0%	15.0%	15.0%
Depreciation as % of Sales	5.5%	5.5%	5.5%	5.5%	5.5%
Transaction Fee Amortization (5 years)	$ 1.0	$ 1.0	$ 1.0	$ 1.0	$ 1.0
Tax Rate	35.0%	35.0%	35.0%	35.0%	35.0%
Cap. Ex. as % of Sales	5.5%	5.5%	5.5%	5.5%	5.5%
Inc. in WC as % of Inc. in Sales	7.0%	7.0%	7.0%	7.0%	7.0%

Uses of Funds	
Purchase Price	$ 200.0
Transaction Costs	5.0
Total	$ 205.0

Sources of Funds	
Senior Debt (@ 9.0%)	45.0
Junior Debt (@ 13.0%)	100.0
Equity	60.0
	$ 205.0

Target Projections		**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Net Sales		170.0	178.5	187.4	196.8	206.6	217.0
COGS		102.0	107.1	112.5	118.1	124.0	130.2
S,G&A		25.5	26.8	28.1	29.5	31.0	32.5
Depreciation		9.4	9.8	10.3	10.8	11.4	11.9
Operating Income		33.1	34.8	36.5	38.4	40.3	42.3
Transaction Fee Amortization		-	1.0	1.0	1.0	1.0	1.0
EBIT		33.1	33.8	35.5	37.4	39.3	41.3
Interest Expense							
Senior Debt	9.0%		4.1	3.0	1.9	0.5	-
Junior Debt	13.0%		13.0	13.0	13.0	13.0	11.5
Total Interest Expense			17.1	16.0	14.9	13.5	11.5
Pre-tax Income			16.8	19.5	22.5	25.8	29.8
Income Taxes			5.9	6.8	7.9	9.0	10.4
Net Income			10.9	12.7	14.6	16.8	19.4
<u>Free Cash Flow Calculation</u>							
Net Income			10.9	12.7	14.6	16.8	19.4
Plus: Depreciation			9.8	10.3	10.8	11.4	11.9
Plus: Transaction Fee Amortization			1.0	1.0	1.0	1.0	1.0
Less: Capital Expenditures			(9.8)	(10.3)	(10.8)	(11.4)	(11.9)
Less: Increase in Working Capital			(0.6)	(0.6)	(0.7)	(0.7)	(0.7)
Frewe Cash Flow			11.3	13.1	15.0	17.1	19.6

Capitalization		**Year 0**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Senior Debt - Beginning Balance			45.0	33.7	20.6	5.7	-
Mandatory Amortization	$1.0		1.0	1.0	1.0	1.0	-
Cash Sweep			10.3	12.1	14.0	4.7	-
Senior Debt - Ending Balance		45.0	33.7	20.6	5.7	-	-
Junior Debt - Beginning Balance			100.0	100.0	100.0	100.0	88.6
Mandatory Amortization	$0.0		-	-	-	-	-
Cash Sweep			-	-	-	11.4	19.6
Junior Debt - Ending Balance		100.0	100.0	100.0	100.0	88.6	68.9
Senior Debt		45.0	33.7	20.6	5.7	-	-
Junior Debt		100.0	100.0	100.0	100.0	88.6	68.9
Equity		60.0	70.9	83.6	98.2	115.0	134.3
Total Capitalization		205.0	204.6	204.2	203.9	203.6	203.3
Senior Debt		22.0%	16.5%	10.1%	2.8%	0.0%	0.0%
Junior Debt		48.8%	48.9%	49.0%	49.0%	43.5%	33.9%
Equity		29.3%	34.7%	40.9%	48.2%	56.5%	66.1%

Exhibit 2 – LBO Return Calculations

Cash Flows to Common Equity		Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
EBITDA		42.5	43.6	45.9	48.2	50.7	53.2
Total Debt		145.0	133.7	120.6	105.7	88.6	68.9
	Exit Multiple	Outflow	Inflows				
	5.5 x	(60.0)	106.2	131.6	159.4	190.0	223.9
	6.5 x	(60.0)	149.9	177.4	207.6	240.7	277.1
	7.5 x	(60.0)	193.5	223.3	255.8	291.4	330.4

Exit In:		IRR						
Year 1	5.5 x	77.1%	(60.0)	106.2				
	6.5 x	149.8%	(60.0)	149.9				
	7.5 x	222.5%	(60.0)	193.5				
Year 2	5.5 x	48.1%	(60.0)	-	131.6			
	6.5 x	72.0%	(60.0)	-	177.4			
	7.5 x	92.9%	(60.0)	-	223.3			
Year 3	5.5 x	38.5%	(60.0)	-	-	159.4		
	6.5 x	51.3%	(60.0)	-	-	207.6		
	7.5 x	62.2%	(60.0)	-	-	255.8		
Year 4	5.5 x	33.4%	(60.0)	-	-	-	190.0	
	6.5 x	41.5%	(60.0)	-	-	-	240.7	
	7.5 x	48.4%	(60.0)	-	-	-	291.4	
Year 5	5.5 x	30.1%	(60.0)	-	-	-	-	223.9
	6.5 x	35.8%	(60.0)	-	-	-	-	277.1
	7.5 x	40.7%	(60.0)	-	-	-	-	330.4

Characteristics of a Good LBO Candidate

The following characteristics define the ideal candidate for a leveraged buyout. While it is very unlikely that any one company will meet all these criteria, some combination thereof is needed to successfully execute an LBO.

- Strong, predictable operating cash flows with which the leveraged company can service and pay down acquisition debt
- Mature, steady (non-cyclical), and perhaps even boring
- Well-established business and products and leading industry position
- Moderate CapEx and product development (R&D) requirements so that cash flows are not diverted from the principal goal of debt repayment
- Limited working capital requirements
- Strong tangible asset coverage
- Undervalued or out-of-favor
- Seller is motivated to cash out of his/her investment or divest non-core subsidiaries, perhaps under pressure to maximize shareholder value
- Strong management team
- Viable exit strategy

Controversy about LBO structures around the world (tax benefits)

One of most controversial issues about LBO structures involving subsequent mergers has been the taxation of the surviving company, in which the leveraged buyer and the target are merged.

Tax authorities across the globe have had a longstanding negative approach towards LBO transactions. In their view, the financial expenses resulting from loans to finance the acquisition of shares of the target should not be deductible for corporate tax purposes by the surviving company. According to them, LBO transactions constitute abusive tax practice to the extent that the transfer of the shares of a target followed by a merger is exclusively aimed at reducing the target's taxable income by increasing its financial liabilities arising from the acquisition transaction.

Tax authorities posit that there is no economic and commercial reason for choosing such a structure other than tax evasion, since the same economic result, i.e. making the investment to the target, could be achieved *via* direct investment in the target rather than an investment *via* a leveraged buyer acting between the main investor (parent company of such buyer) and the target.

Consequently, where the tax authorities deem that the main aim of a specific LBO transaction is to abuse tax advantages as stated above, they reject it. Increasing number of countries adopt strict anti-abuse rules so that taxpayers setting up controversial structures, such as the LBO structures, must prove substantial non-tax reasons (valid business and commercial considerations).

Management Buyouts (MBOs)

Management buyouts are similar to LBO, except that the management team of the target company acquires the company rather than a financial sponsor. For example, the sole owner of a private company might be nearing his twilight years and wishes to exit the business he started years ago. The management team might believe strongly in the prospects of the company and agree to buy out the owner's equity interest and assume control of the company.

> Tax authorities across the globe have had a longstanding negative approach towards LBO transactions. In their view, the financial expenses resulting from loans to finance the acquisition of shares of the target should not be deductible for corporate tax purposes by the surviving company. According to them, LBO transactions constitute abusive tax practice to the extent that the transfer of the shares of a target followed by a merger is exclusively aimed at reducing the target's taxable income by increasing its financial liabilities arising from the acquisition transaction.

From a manager's perspective, leveraged buyouts have a number of appealing characteristics:

- Tax advantages associated with debt financing
- Freedom from the scrutiny of being a public company or a captive division of a larger parent
- The ability for founders to take advantage of a liquidity event without ceding operational influence or sacrificing continued day-to-day involvement, and
- The opportunity for managers to become owners of a significant percentage of a firm's equity.

A special case of a leveraged acquisition is a management buyout (MBO). In an MBO, the incumbent management team (that usually has no or close to no shares in the company) acquires a sizeable portion of the shares of the company. Similar to an MBO is an MBI (Management Buy In) in which an external management team acquires the shares.

An MBO can occur for a number of reasons as under:
The owners of the business want to retire and want to sell the company to the management team they trust (and with whom they have worked for years).

The owners of the business have lost faith in the business and are willing to sell it to the management (who believes in the future of the business) in order to get some value for the business.

The managers see a value in the business that the current owners do not see and do not want to pursue.

In most situations, the management team may not have enough money to fund the equity needed for the acquisition (to be combined with bank debt to constitute the purchase price) so that management teams work together with financial sponsors to part-finance the acquisition. For the management team, the negotiation of the deal with the financial sponsor (i.e., who gets how many shares of the company) is a key value creation lever. Financial sponsors are often sympathetic to MBOs as in these cases they are assured that the management believes in the future of the company and has an interest in value creation (as opposed to being solely employed by the company). There are no clear guidelines as to how big a share the management team must own after the acquisition in order to qualify as an MBO, as opposed to a normal leveraged buy-out in which the management invests together with the financial sponsor. However, generally an MBO is a situation in which the management team initiates and actively pushes the acquisition.

MBO situations lead management teams often into a dilemma as they face a conflict of interest, being interested in a low purchase price personally while at the same time being employed by the owners who obviously have an interest in a high purchase price. Owners usually react to this situation by offering a deal fee to the management team if a certain price threshold is reached. Financial sponsors usually react to this again by offering to compensate the management team for a lost deal fee if the purchase price is low. Another mechanism to handle this problem is earn-outs (purchase price being contingent on reaching certain future profitability).

There probably are just as many successful MBOs as the unsuccessful ones. Crucial for the management team at the beginning of the process is the negotiation of the purchase price and the deal structure and the selection of the financial sponsor.

Secondary and tertiary buyouts

A secondary buyout is a form of leveraged buyout where both the buyer and the seller are private equity firms or financial sponsors (i.e., a leveraged buyout of a company that was acquired through a leveraged buyout). A secondary buyout will often provide a clean break for the selling private equity firms and its limited partner investors. Historically, given that secondary buyouts were perceived as distressed sales by both seller and buyer, limited partner investors considered them unattractive and largely avoided them.

The increase in secondary buyout activity in 2000s was driven in large part by an increase in capital available for the leveraged buyouts. Often, selling private equity firms pursue a secondary buyout for a number of reasons:

Sales to strategic buyers and IPOs may not be possible for niche or undersized businesses.

Secondary buyouts may generate liquidity more quickly than other routes (i.e., IPOs).

Some kinds of businesses – e.g., those with relatively slow growth but which generate high cash flows – may be most appealing to private equity firms than they are to public stock investors or other corporations.

Often, secondary buyouts have been successful if the investment has reached an age where it is necessary or desirable to sell rather than hold the investment further or where the investment had already generated significant value for the selling firm.

Secondary buyouts differ from secondaries or secondary market purchases which typically involve the acquisition of portfolios of private equity assets including limited partnership stakes and direct investments in corporate securities.

If a company that was acquired in a secondary buyout gets sold to another financial sponsor, the resulting transaction is called a tertiary buyout.

Report corner

- Travel and Hospitality Industry gone digital, FICCI – March 2018

  India's Travel sector has expanded in the recent years, driven by the increase in domestic spend, internet penetration and availability of smartphones. Technology today plays a ubiquitous role in shaping the travel industry. This report provides a quick look at the current pace of digital disruption, consumer trends and innovation.

  Read the full report here : https://bit.ly/2HyNplh

- Affordable Housing : The Next Big Thing, FICCI – March 2018

  The Indian real estate and urban infrastructure sector has witnessed transformative reforms in the past few years. This report brings in light some interesting facts to bridge the housing shortage gap in India and key inhibitors of private sector participation in affordable housing segment. It provides a broad understanding of basic components of the Affordable Housing Scheme along with the policy level interventions by the Government of India to foster the public private participation in the sector.

  Read the full report here : https://bit.ly/2HxcmNL

- Transformation of on-road automobiles to electric vehicles in India, KPMG – March 2018

  The report attempts to understand the negative impacts of Internal Combustion Engines on energy security, economy and environment in India. It looks into regulatory aspects of current mitigation measures being adopted by the government and explores the available options of future mobility in India. It discusses the mobility ecosystem for pure electric vehicles and hybrids/ plug-in hybrids and how hybrid retrofit kits can serve as transitory technology in achieving full electric mobility in the future. The report also suggests potential policy and regulatory measures for efficient transformation of on-road vehicles into electric vehicles in India

  Read the full report here : https://bit.ly/2HGFwaZ

- Top 20 reasons why Startups fail, CBInsights – March 2018

  From lack of product-market fit to disharmony on the team, this report breaks down the top 20 reasons for startup failure by analyzing 101 startup failure post-mortems

  Read the full report here : https://bit.ly/2Hu58KC

About MNA Caps

MNA Caps is a boutique **Mergers & Acquisitions (M&A) valuation and transactions advisory** firm, based in Mumbai, having a strong understanding of the Indian corporate finance environment. The firm specialises in providing **end-to-end solutions including risk assessments** in the complex areas of acquisitions, fund raising, and strategic transactions, corporate restructuring and allied activities.

MNA Caps collaborates with sector specialists having strong track record and deep industry experience to provide its clients the desired outcome. MNA also aims to liaise and work with the regulators to facilitate 'ease of doing businesses in India.

The firm is founded by Vishal Laheri who has over 17 years of experience in Strategy, M&A and transactions advisory across **Financial Services, Technology Media & Telecom and Infrastructure & Power sectors**. Vishal has worked on several large and complex M&A transactions during his tenure with Reliance Group (2005-2015) and Ambit RSM (Now PWC India) (2002-2005) and has developed vital relationships with several renowned promoters, foreign and India institutions, funds and C-Level executives.

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