Entering restricted markets

Sidharth Bhasin, Denise Ho and Sriram Kilapakkam discuss tactics to overcome some of the operational challenges of Indian investments in the Asia Pacific region

Indian pro-liberalization advocates frequently bemoan the slow pace at which many of India's industrial sectors are opening up to foreign direct investment (FDI). To its credit, India has made positive strides on the FDI front recently. Its relaxed retail policy, for example, has attracted interest from companies such as Walmart, IKEA and fashion retailer H&M, although political and other concerns have so far prevented some retailers from moving in.

Given the recurrent focus on FDI restrictions within the country, the difficulties Indian acquirers face outside India are often overlooked. In this article we address some issues we have encountered as lead transactional counsel on M&A deals in the Asia Pacific region. Many acquirers are tapping opportunities in this region and we have guided some of them through complex, multi-jurisdictional, cross-border acquisitions in Asian jurisdictions, many of which have idiosyncratic restrictions on foreign investment.

In addition to the legal restrictions, acquiring a business in Asia Pacific involves operational and execution challenges. These sometimes relate to the level of sophistication of some targets, which may affect the availability of "kosher" financials, the negotiation process, and the execution of an M&A deal in general. It is, therefore, important for legal counsel to find practical solutions to issues while protecting the interests of clients and achieving commercial objectives.

Deal structuring

Legal restrictions that could impact deal structuring operate both at the level of the jurisdiction of the target and the jurisdictions in which its operating subsidiaries are incorporated. Some Asia Pacific jurisdictions require a minimum number of local resident shareholders and/or directors on the boards of companies. Others have moved toward adopting national security-related restrictions on investments in sensitive sectors, similar to those of the Committee on Foreign Investment in the United States.

In our experience, working with local counsel at an early stage to identify and address regulatory and other local law issues that may impact the deal structure and economics is critical to the smooth and timely execution of deals. In a recent transaction, during due diligence we discovered significant potential liabilities that the local government and

certain third parties could claim against one of the target's subsidiaries in a South-East Asian country due to a peculiar local law requirement.

We explored several possible solutions to this issue with the deal team (business, financial, tax and legal), including obtaining a specific indemnity secured by a partial holdover of the purchase price. However, in the end, based primarily on commercial considerations and the risk matrix, we decided to ring-fence those liabilities and leave them with the seller by changing the corporate and acquisition structure. In this way, despite implementing a significant change in the structure we were able to get the deal done in a timely and cost-efficient manner, in large part because we identified and dealt with the issue early on.

The local regulatory environment relating to FDI is one of the main issues that impacts deal structuring. The structuring of the transaction with the target is particularly critical where the "crown jewel" asset that is of paramount interest to an acquirer is held by a subsidiary of the target and the subsidiary is located in a jurisdiction with FDI restrictions.

In a recent transaction we identified certain high-risk FDI-related issues in a crown jewel subsidiary of the target that was located in a South-East Asian country. While we could not eliminate the issues entirely due to local regulatory conditions, we turned to the expertise of our various specialists around the globe (tax, regulatory, derivatives, compliance and others) and worked with local counsel to structure the deal and include certain measures at the subsidiary level to effectively reduce the risk to "low risk/low probability". We also put in place a post-closing mechanism that would over time further reduce the risk profile. We did this without disrupting the deal timing and achieved the economic effect desired by the acquirer.

Financing

Given recent economic conditions, obtaining financing for an M&A deal has become one of the most critical aspects of deal execution. Generally speaking, many top tier Indian companies have strong banking relationships in India and acquirers sometimes assume that financing will be easily available based on such relationships. However, those relationships may not always transcend borders, especially in a sluggish credit market and faced with adverse market conditions.

Some Indian companies have been caught on the wrong side of their financing assumptions and found it difficult or expensive to obtain financing. We advise our clients to approach banks at an early stage to get a sense of their ability to finance the deal. We tend to remain closely involved in the financing process to make sure issues relating to the M&A part of the deal or the financing are identified and resolved in a timely manner.

While acquirers typically want to ring-fence the financing and ask the banks to provide financing based on the target's operations and financials, banks sometimes insist on guarantees from Indian corporate parents. Such guarantees may require Reserve Bank of India approval or involve other regulatory considerations, such as net worth-based restrictions, which could impact the timing of the deal. We work with local counsel in such cases to ensure that a proper financing structure and arrangements are in place for outbound acquisitions. Where financing is not available in a timely manner, we work with our clients and alternative financing sources to devise ways to raise bridge financing for the deal.

Price adjustments and holdback

M&A deals in Asia Pacific present novel challenges. While it is common to see purchase price adjustments based on working capital and certain other metrics, many of the challenges faced require out-of-the-box thinking and creative solutions.

An issue we confronted recently was the non-availability of a complete and reliable set of audited financial statements of the target prior to signing and closing of the transaction. In some parts of the world this would have been a deal-breaker from the start. However, since our client saw real synergies between its own business and that of its target, it was keen to move ahead.

Cash trapped: Many top tier Indian companies have strong banking ties in India, however obtaining financing overseas may be tricky as those relationships may not always transcend borders.

We worked with the target's management to produce a set of projected financials on which to base a heavily negotiated and highly structured pre-closing and post-closing purchase price adjustment. We added another layer of protection for our client by securing the holdback of part of the purchase money via a robust escrow (larger than what we would typically see if the financials were in order), from which any purchase price adjustment or indemnity claims would be recovered.

The holdback and escrow of part of the purchase money provided two other benefits for our client. Firstly, the holdback created an incentive for certain selling shareholders (who were and continued to be part of the management of the target) to address certain non-compliance identified during our due diligence within a stipulated time period after the closing as it would secure the staggered release of the purchase money from the escrowed funds. Secondly, the holdback helped address the issue of lack of recourse due to the post-closing dissolution of the offshore selling entity.

In our experience, the lack of accounting and financial housekeeping in a target in an emerging market has generally been a scalable barrier for Indian clients who have relied on creative but suitable solutions to address these risks.

Using stock as payment

We have seen some Indian acquirers willing to issue stock as part payment in some of our recent deals. This cuts against the view that Indian promoters are unwilling to dilute their ownership stake in their businesses. While using stock as payment has several benefits, it creates an additional layer of complexity in the deal.

Depending on the size and structure of the stock issuance, it may be advisable to deal with the M&A component and the stock issuance as two separate yet interconnected transactions. It is important for the lead transaction counsel to effectively quarterback these transactions and to have parallel work streams that function seamlessly to ensure that these interconnected transactions progress and close on time.

Sometimes an acquirer may be too focused on the M&A element and fail to appreciate the implications of having the seller become its shareholder. It is our role to protect the acquirer's interests and ensure that the dilution due to the stock issuance does not result in any unintended consequences for the acquirer.

It is also important to note that depending on the jurisdictions involved, sellers may face legal limitations in owning stock of a foreign company. These issues should be identified early so that they can be worked around without impacting deal timing.

Anti-corruption

Acquisitions in the Asia Pacific region by sophisticated India-based funds as well as large multinational companies experienced in deal-making have typically included comprehensive US-style anti-corruption representations as inspired by the Foreign Corrupt Practices Act (FCPA). With smaller, domestic companies and in the case of acquirers without any exposure to the US market, we have seen greater reluctance in providing such representations. Over time, we have seen Indian acquirers become familiar with the risks of insufficient protection on this front. This is primarily due to a tightening of anti-corruption laws in many jurisdictions in Asia and a convergence toward US standards and practices. In addition, these acquirers are often themselves parties to transactions with sophisticated counterparties that have provided similar representations.

The risks of being caught by FCPA or other anti-corruption laws can compromise not just an M&A deal, but potentially the viability of the target business as a going concern. The latter could, in turn, have a potentially disastrous effect on the acquirer. We typically involve our FCPA experts who work with local counsel to craft robust but practical anti-corruption contractual protection for our clients in outbound M&A deals as well as put in place a post-closing FCPA-compliance programme where the target does not already have one.

Post-closing issues

The effectiveness of carefully crafted and negotiated transaction documents is often tested during the post-closing period. Third-party liabilities incurred in the pre-closing period are sometimes discovered post-closing. This happened in a recent transaction. Since we were prepared for this as a result of our due diligence efforts – and therefore provided adequate contractual protection in the transaction documents – our client was able to invoke against the seller an indemnity claim under the purchase agreement that was backstopped by an escrow and therefore access the escrow funds for reimbursement of the claim.

In jurisdictions which do not maintain public litigation or security interest search systems, having robust indemnity provisions has proven to be critical. Local counsel issue diligence reports covering the limited diligence they have been able to perform in such cases but real economic protection for the client often comes from having robust, effective and practical recourse in place in the contractual documentation.

Conclusion

Acting as international counsel on outbound M&A in the Asia Pacific region is a challenging and professionally rewarding experience on account of the breadth of deals and complexity of issues involved. To help our clients navigate the M&A landscape, we propose transaction-specific and practical structuring options and solutions, and work with our clients and other advisers including financial advisers and local counsel to help achieve commercial objectives.

Asia Pacific is one of the fastest growing regions in the world but at the same time one that is constantly changing and adapting its laws and regulations with a view to importing international best practices for corporate and business purposes. This environment provides fertile ground for us to add value to our clients, allowing us to build up enduring client and referral relationships in this important region. ■

Sidharth Bhasin is a partner at Shearman & Sterling where Denise Ho and Sriram Kilapakkam are associates. This article does not contain a full analysis of the matters presented and should not be relied on as legal advice. Shearman & Sterling does not practise Indian law. This is a summary that we believe may be of general interest to readers for purposes of information and is based on our professional experience as international counsel on cross-border M&A transactions.