Funding of Indian subsidiaries

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Liberalisation in India has resulted in significant inbound foreign investment. As Indian operations of foreign businesses grow, foreign shareholders grapple with the best ways to finance these operations and repatriate some of the profits – partly due to the Indian regulatory system, which strictly regulates capital account transactions. This article examines some key ways of financing Indian operations of foreign shareholders. But it will depend on the specific circumstances in each case to determine which option is best suited for a particular Indian subsidiary.

Investment through shares and convertible instruments. Foreign companies can finance their subsidiary's operations through investment in shares and convertible instruments. The law allows investment through equity shares, compulsory convertible preference shares, compulsory convertible debentures and warrants.

The investment in the aforesaid instruments is treated as capital investment by the foreign investment law of India, but such capital investment is subject to certain conditions including: (1) Restrictions on the level of capital investment in specified sectors, e.g. permissible capital investment in multi-brand retail is up to 50%; (2) the need to specify the manner of pricing the instrument to ensure that the instrument is not issued/transferred at a lower price than its fair market value (pricing compliance); (3) a specified time for the allotment of such instruments; (4) reporting such capital investment within a specified timeline.

For example, when a foreign shareholder wants to fund its subsidiary for working capital needs, the foreign shareholder may want to evaluate, prior to the capital investment, the pricing compliance. Considering the pricing compliance mandates that the instrument be not issued at a price lower than its fair market value, the foreign shareholder will need to evaluate whether such pricing compliance will result in the capital investment being much more than what is needed.

However, there are some exceptions to the pricing compliance for a private company or a public unlisted company, e.g. issuing the instrument through a rights issue. Instruments issued through a rights issue can be issued at a price similar to the price offered to an Indian shareholder. For wholly owned subsidiary of a foreign shareholder, however, this exception may need to be examined given that the subsidiary may not have an Indian shareholder.

Considering the above, capital investments may not always be the optimum method for funding as foreign shareholders may not want to lock in huge capital for inordinately long periods. Further, repatriation of profits from such subsidiaries has certain restrictions under applicable law and is coupled with attendant tax leakages.

External commercial borrowings. A foreign shareholder can also fund through debt. However, third party loans are costly in India compared to borrowing overseas and are not easily available. But there are some viable debt alternatives which foreign parents can explore to finance their Indian subsidiaries, earn some interest and recover the money in due course.

Under the applicable law, an Indian subsidiary can raise debt from its foreign shareholder by way of external commercial borrowings (ECBs). In this context, a direct foreign equity holder with minimum 25% direct equity holding in the Indian subsidiary, an indirect equity holder with minimum indirect equity holding of 51% in the Indian subsidiary, or a group company with a common overseas parent, is permitted to provide an ECB to its Indian affiliate. The borrowings may fall under any of the three categories – either with or without approval of the central bank (RBI) – depending on the business of the Indian subsidiary, the end use of the ECB proceeds, the currency of borrowing and the average tenure of the ECB. Further, the applicable law stipulates that the Indian subsidiary is to maintain a debt equity ratio of 7:1. However, this ratio is not applicable if the total of all ECBs raised by an Indian entity is up to US$5 million or equivalent.

While the applicable law requires RBI approval for ECBs not satisfying certain conditions set out under the relevant regulation, such approval may be time consuming and may not meet the immediate needs of the Indian subsidiary.

Masala bonds. In September 2015, RBI permitted Indian corporates to issue rupee-denominated bonds (nicknamed as Masala bonds) under the ECB regime. The Masala bonds regime is more liberal than the ECB one. The pool of lenders is increased and any person from a Financial Action Task Force compliant jurisdiction can subscribe to such bonds. The requirement of holding a minimum equity percentage as per the ECB guidelines for foreign equity holders is not applicable, and an equity holder with less than 25% equity in the Indian company would also be eligible to subscribe to such bonds.

Non-convertible debentures. Another avenue available is the corporate debt market. A group company of a foreign shareholder can register as a foreign portfolio investor (FPI) under the Securities and Exchange Board of India's prescribed regulations. The registration process is straightforward and typically an FPI registration can be completed within a few weeks. An FPI is permitted to invest in listed or unlisted non-convertible debentures (NCDs). The minimum residual maturity of such NCD's should be 1-year subject to certain conditions set out under the applicable law. The NCDs can be secured or unsecured. The issuer has considerable flexibility on how to use the proceeds and the amount of interest or redemption premium to be paid on such instruments.

This route has been used amply, especially by foreign funds, to finance Indian portfolio companies. This option provides more flexibility than the ECB option in raising funds from foreign shareholders. However, there would be certain disclosure requirements that need to be considered.

By way of business arrangements. Today a good number of Indian subsidiaries, commonly in the IT sector, have been set up to provide services only to its foreign shareholder based in a jurisdiction outside India. These Indian subsidiaries enter into service arrangements with its foreign shareholder and receive funds as part of their business income for providing services to such shareholder. The applicable law does not stipulate a cap on funds received from a foreign shareholder as part of a service contract between the Indian subsidiary and the foreign shareholder. Therefore a foreign shareholder can raise funds for his subsidiary through such an option. However, certain tax implications, such as transfer pricing, may need to be examined.