Innovative financing strategies for growth

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Summary points

► Rather than expend a lot of time and resources at the time of planning to raise finance, companies should pay attention to liability management over a period of five to seven years after obtaining the finance. Sound liability management can save a company at least 1% pa in interest costs.

► Volatility is a friend of the market when managing liability.

► Once every few years, businesses get a very attractive opportunity to issue long term debt. Young professionals should develop an eye to identify this chance which may come only once or twice in their lifetime.

► Emerging markets seemed like a successful growth story in 2012 and the first half of 2013, but that trend reversed as quickly as it started. Hence proper timing is very important.

► Accessing export credit markets is the cheapest way to raise foreign currency, and the best route for offshore financing.

► The corporate bond market has not been able to offer competitive financing since 2005. It is a poor option for any company that is below AA+ category. Taking term loans from banks is a cheaper and less intensive option.

► Patience pays in the world of finance.

► The year 2013 has seen markets rebounding globally, with increasing numbers and volume of IPOs.

► RBI has now given Indian companies a two-year window to list directly outside India without prior domestic listing.

► Sixty percent of all IPO candidates start preparing 12 to 24 months before getting listed. The success rate globally is 83%.

► Fifteen percent of IPOs come from private equities. This figure is higher in 2013.

► It is important to have a Plan B because of the 17% risk factor.

► Top ranking sectors for IPOs are technology, industrials and materials. Real estate is now getting launched in the market.

► Investor recommendations accord the highest ranking to corporate earnings. Hence that is the best window for a company that is IPO-ready.

► There are good indicators to find the right IPO window.

► Investor sentiments should always be considered when planning an IPO. They determine the success of the IPO.

► The business strategy must lead the decision about the destination for the IPO. The example of Prada is a good case in point.

► The right time for Indian companies to plan for overseas listing is now.

► In the earlier regime, a company that wanted to be listed abroad had to first create an overseas company to get listed. That route raises several tax issues.

► It is now possible to create a simpler structure. A hitherto unlisted company can simply do an overseas listing and issue shares. This can be done in 124 countries.

► The transfer of ADRs-GDRs between non residents is tax exempt; conversion of ADRs-GDRs into shares and transfer of shares is also non-taxable to a large extent. Two way fungibility has not been prescribed in the guidelines for unlisted companies.

► Another concept in overseas listing is the Business Trust (BT) concept. The business ethos of a BT is similar to that of an unlisted company listing outside.

It pays to be patient

Access and timing are intrinsic to raising good finance. It makes more sense to keep things simple and stick to a plan rather than going overboard on innovative strategies. Although most people spend a lot of time and attention to getting the timing right and planning the right moves when acquiring the finance, what is more
important is how they manage their liabilities over the next five to seven years after they have raised the money. Liability management is of far more value to a company than what is done at the time of borrowing. In this respect, volatility can be a friend, when dollar swap rates and OIS rates are blended with debt. Good liability management can save the company at least 1% pa in terms of interest costs.

Once in about a decade, businesses get a much better option to issue long term debt than they could ever have thought of. In India, most companies would have issued their 10 year debt at 6.8%. But there were opportunities between 5% and 5.5% since last May when the taper talks started. This was a once-in-a-decade prospect. Young professionals may come across such a possibility only once or twice in their lifetime. They should develop the astuteness to be able to identify the opportunity quickly and use it sensibly, without being influenced by their bankers or consultants.

As treasury yields go down, the price for emerging market credit often goes up. It is very rare to see euphoria about emerging market credit when yields are low. The only time these two entities came together was in 2012 and the first half of 2013. Those 18 months saw record low interest rates in the US. Everybody felt there was no growth, and there was no taper talk. Quantitative Easing (QE) became the norm; people felt that it would continue indefinitely. Companies in emerging markets were giving better yields than household names in the US with similar ratings. People expressed confidence the emerging market growth story. A lot of money went into emerging market funds, drastically driving down the spreads by the end of 2012. But the trend reversed as quickly as it started. Hence timing is everything. One has to be patient and wait for these 10 year cycles.

Accessing export credit markets is far more interesting and does not require a waiting period of 10 years to get the best results. It may be tough, but it is also the cheapest way to raise foreign currency. The only caveat is that it has to come with capital expenditure and with the export of goods and services. If it works, the consensus rate for five to 8.5 years is 2.37% in dollars. Even adding premium to that, we end up with 3.5% to 3.75% long term financing in dollars. This is the cheapest source of money today.

When it comes to offshore financing, working with export credit agencies is the best route. They deliver the longest term credit at the most effective rate. Public markets are appealing, but not as cost effective. They end up being at least 1.5% to 2% more expensive than financing under export credits. Public markets are the best option for those who have the rating and want to issue for maturities between 10, 20 and 30 years.

Reliance Industries made a departure from its plans for capital expenditure starting mid 2012; during the last 18 months the company has engaged with six export credit agencies round the world to source equipment and services. This will be the cheapest long term financing that Reliance has ever raised.

As far as the Indian bond market goes, the story is not a happy one. The corporate bond market has not been able to offer competitive financing since 2005, when that sector became active. For AAA companies at five years, 8.98% is the average return over the last eight years. For AA+ companies that value goes up to 9.3%. Borrowing at this rate can never be competitive. A comparison of base rates with what is obtainable in the bond markets reflects AA+ pricing, which is imperfect. Hence for most people, bank financing at base rate is still a better option than struggling with the bond market. The latter is not suited to anyone who drops off AA+ category. This imperfection of the corporate bond market has often been the cause of complaint about its non-development. From a rating point of view, taking term loans from banks is probably cheaper and less intensive.

Patience pays in the world of finance. For those who have the luxury of being patient, the opportunity of an attractive transaction presents itself every few years.

**Good news for Indian companies**

The year 2013 has been the first after three years to see increasing numbers and volume of IPOs. Globally, many markets are rebounding. This is good news, because for the first time, Indian companies are allowed to list directly outside India, without prior domestic listing. Companies now have the option of going to hundreds of stock exchanges around the world.

Statistics reveal that sixty percent of all IPO candidates start preparing about 12 to 24 months before getting listed. Eleven percent of global entrepreneurs are listed in overseas exchanges. Fifteen percent of IPOs come from portfolios of private equities. This figure is much higher in 2013, because the large number of IPOs from private equity firms in the US and Germany. Globally, of the companies that applied for listings, 83% succeeded. Of the remaining 17%, 22% succeeded in the second attempt. The others had to withdraw. This
shows the importance of having a Plan B. Most IPOs take place in the fourth quarter, when investors have a clear view of the annual figures. Eighty nine percent of them are priced in the book billing range or above.

The top ranking sectors are technology, industrials and materials, both by volume and number of IPOs. Real estate and REITs are now getting launched in the market, being no 1 by volume and no 3 by numbers this year. This is due to the fact that markets are now beginning to come out of the financial crisis, and investors are looking for asset rich businesses and predictable cash flows. They like the certainty that real estate can provide.

What is the best IPO window for a company that is IPO-ready? Investor recommendations put corporate earnings at the top. They also give importance to macro economic conditions, stability in equity markets, cash inflows and recovery in market valuations. Hence there are good indicators to find the right IPO window, starting with the index. A study of the volatility indices and the company’s selection indices will give a it a feel about the IPO window.

The global index map shows positive returns on six and 12 month periods, which gives investors a positive experience with equities. This is good for IPOs and cross listings. Prime destinations are Europe, North America and Asia. The most active issuers are from mainland China, and they usually go to Europe and to the US. European stock exchanges welcome 43% of all global listings. Smaller Indian companies under the dual listing regime prefer AIM, which is the junior London stock exchange while larger companies prefer the main London market. There is a huge spread in market capital, due to the fact that company sizes span a very broad range.

Investors are a company’s clients in an IPO, and their sentiments should be considered. They determine the success or otherwise of the IPO. Investor surveys show that they place a high value on corporate governance. They also expect a compelling reason for listing abroad. Companies should have a visible and reasonable explanation for why they want to go overseas. Merely going by high valuation does not impress investors. The CFO and CEO of the company also need to be active in the market, and engage with investors through road shows and other touch points.

Companies like to get listed in exchanges where they get the greatest valuation. Other factors that influence their decision are compliance costs, preferences, and the business strategy. The latter must always lead the decision along with the benefits of a listing on the IPO decision. Individual perspectives also play a role; each business entity will have a different perspective and differing criteria for listing, in keeping with their business strategy.

Let us examine Prada as a case study. Prada’s primary listing is in Hong Kong rather than in Milan. The company took that decision consciously to draw on China’s growing middle class that likes to invest in global brands. For a company interested in building up retail stores in China, it makes sense to raise money in renminbi, not in euros. Many European brands are strategically listing their IPOs in Hong Kong since it is perceived as the door to mainland China.

Where to list will ultimately depend on the company’s perspective and its strategy. Indian companies have a time frame of two years, so the time is right to start thinking about this now, with an IPO-readiness assessment. An IPO-readiness assessment begins with the destination. This identifies the rule books that need to be followed and forms the basis for all other readiness check points. Going public is a huge project, and there are bound to be pitfalls along with the rewards.

**Two-Year Window Offers Tax-Friendly Options for Cross-Border IPO Listings**

This is the right time to invest overseas, because of the RBI notification that allows unlisted companies to list abroad directly without being required to list in India.

Earlier, promoters would open and create an overseas company which would become the listing vehicle which would own the operating company. It would then get listed in the overseas markets. So we had the promoter co-owning in India, owning outside India and then owning the Indian company through that overseas structure. That raised several issues: when the Indian holding is transferred to an overseas company, is there a capital gains tax implication? Indian tax law states that if the income of a resident is pushed to a non resident in some form, where the resident has control over the income or asset of the non resident, then the income is deemed to be earned in India and taxed accordingly.
Yet, companies adopting this route succeeded because they had a business rationale and a commercial purpose. The key business rationale was that the overseas listing gave them a better footprint, and therefore better overall value creation for the business.

What happens when the structure is flipped back and the shares of the overseas company are sold? Since primary value is derived from India, the transfer of those shares could create a taxation event in India. As the law stands today, every transfer of this company will be subject to tax in India. This is a risk, and more clarifications are needed. Going forward, one will also have to see whether the place of effective management or the controlled foreign corporation taxation rules will make it even more complicated.

What has changed now? It is now possible to create a simpler structure using the current regulations. An operating company in India does not have to create a structure to go out. It can simply do an overseas listing and issue the shares. They are held by the custodian in India through its branch; the custodian in turn issues ADRs and GDRs to the investors. Until now, this company had to be listed in India to be able to have an ADR-GDR. The new rules allow it to do an ADR-GDR directly by issuing its own shares. The rules stipulate that it needs to be listed in IOSCO/FAT compliant jurisdictions, or where SEBI held bilateral agreements. This jurisdiction encompasses 124 countries, which covers almost all markets. The listing needs to be compliant with FDI guidelines. Pricing will be DCF because shares are being issued by an unlisted Indian company. The company needs to identify the quantum of shares it is issuing and its conversion ratios upfront. It is not open at a later date.

The instrument being issued by the Indian company is a share capital. When shares are issued, it is free usage. Exceptions are when making downstream investments; FDI guidelines need to be complied with; similarly, stock market or real estate investments have other norms that need to be satisfied. Other than that, everything else is eligible. What is being issued is a capital instrument not subject to restrictions of the debt or ECB types. The only downside is that the eligibility criteria for unlisted companies are yet to be notified by the government. This window is currently open till the end of October 2015.

This is a much safer tax option. The transfer of ADRs-GDRs between non residents is tax exempt; conversion of ADRs-GDRs into shares and transfer of shares is also non-taxable to a large extent. They are governed by the 1993 guidelines that the government issued on FCCB and ADRs-GDRs. It is said that when an ADR-GDR is converted to a share, the market price on the date of conversion becomes the cost price of those shares. So there is hardly any δ, even if the Indian company remains unlisted.

Two way fungibility has not been prescribed in the guidelines for unlisted companies. However, they have also not prohibited it, so more clarity will be needed from the RBI.

The other basic concept in overseas listing is the Business Trust (BT) concept. The BT is basically a steady income generator who invests in an Indian company which is operations and asset heavy. The BT does not look at capital appreciation, but at the annual income flow. The promoter can divide this entity into an asset company and an operating company. The asset company then provides the asset to the operating company on lease. This asset company is then held through the business trust. The promoter needs to create a sponsor and own at least 26% of the BT. So there is a steady flow of income, which is pre-determined. Companies that are into office space leasing, like India Bulls, have brought it under the BT structure.

The Singapore stock exchange is very flexible in terms of getting these BTs listed. This is a good source of income, and most of the infra companies including port companies are using this as a good avenue to raise money abroad. The business ethos is similar to that of an unlisted company listing outside. One has to look for structures to secure more return to the BT in a tax efficient manner. This is an important way of raising funds, and BTs should try and maximise on their returns.

The contents of this paper are based on presentations by Alok Agarwal, CFO, Reliance Industries Ltd, Martin Steinbach, EMEIA and GSA IPO Leader and Amrish Shah, Partner and National Leader, Transaction Tax, at the EY CFO Forum held in December, 2013. The views expressed are those of the speakers.
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