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High growth companies and how to fund them – a real driver of economic growth?

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The working session in Prague is entitled "*High-growth companies and how to fund them – a real driver of economic growth?*" In the working session we plan to address funding alternatives for high-growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high-growth companies. This questionnaire mainly concentrates on these two topics in relation to high-growth companies, but will also cover commercial and regulatory opportunities and constraints.

1. CORPORATE FINANCE – FUNDING ALTERNATIVES

1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

1.1.1 Largely, investments in high growth companies in India are made by way of acquisition of ordinary equity shares, giving the investor dividend and voting rights in the investee company as also through convertible instruments through which voting rights are contractually derived. Under the foreign exchange regulations of India, fully, compulsorily and mandatorily convertible preference shares and fully, compulsorily and mandatorily convertible debentures are considered as equity and are permitted to be issued to a foreign investor subject to compliance with pricing guidelines/ valuation norms prescribed under the foreign exchange regulations of India. Non-convertible/ optionally convertible/ partially convertible preference shares and non-convertible/ optionally convertible/ partially convertible debentures are considered as debt under foreign exchange regulations in India, and therefore a foreign investor proposing to invest in such instruments is required to comply with the external commercial borrowings guidelines of India.

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

1.2.1 Equity shares and convertibles: Ordinary equity shares entitle the investor with voting rights and dividend rights, and therefore, from the point of view of a strategic investor investment in ordinary equity shares may be the preferred instrument. Also, convertibles are another option for investment under which voting rights are contractually conferred. These instruments will enable the investor in having a say in the management and business decisions of the investee entity, thereby granting a control in proportion to the stake held by such an investor in the investee entity.

1.2.2 Preference shares: Preference shares entitle the investor with voting rights in respect of matters pertaining only to preference shares and the investor will also be entitled to a preferential right on dividends (over equity shares) and a preferential right to repayment in the event of winding up of the investee entity. Having said that, as under Indian law, preference shareholders cannot be granted with any voting rights, investors seeking a control over the investee entity may not prefer using preference shares for their investment.

1.2.3 Debt instruments: Investments in debt instruments will require compliance with the external commercial borrowings regulations prevailing in India which *inter alia* impose end use restrictions on the funds, minimum maturity requirements, restrictions on amount which can be raised, eligibility criterion for borrowers and lenders. Therefore, from an investment perspective, investment in a pure debt instruments is not a lucrative option.

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

1.3.1 Until recently, a major roadblock was faced by foreign investors in including exit options in definitive agreements while investing in Indian companies, as the Reserve Bank of India did not permit options granting an exit right to foreign investors and such options were concerned as debt instruments. However, recently, the Reserve Bank of India has clarified that investment in instruments with exit options are permitted subject to certain conditions such as lock-in requirement of one (1) year and valuation requirements. The Reserve Bank of India has also specified that investors exiting by exercise of such exit options cannot exit at a pre-determined/ assured price and a valuation as per the methods prescribed will be required to be undertaken at the time of exit. This is of a major concern to private equity investors as now investment agreements cannot specify an assured/ guaranteed rate of return.

1.3.2 Another regulatory constraint faced by investors in India is the valuation requirements required to be complied with. As per the foreign exchange regulations of India, at the time of making an investment, the price of the shares subscribed to or acquired (other than under through the charter documents of the company) is required to be equal to or higher than the price of shares calculated as per the discounted cash flow method. Further, at the time of exiting the investment (other than exit by way of put options), the price of shares is required to be lower than the price of shares calculated as per the discounted cash flow method.

1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

1.4.1 Crowdfunding as a funding alternative is at a nascent stage in India, although certain online crowdfunding platforms have been launched in recent times. Given that, the practice of crowdfunding is limited to social and cultural projects and very few initiatives of crowdfunding have been noted in mainstream entrepreneurship. Securing loans from a financial institution or bank is considered as an easier and efficient mechanism than crowdfunding.

1.4.2 Recent press reports suggest that the securities market regulator in India, i.e., the Securities and Exchange Board of India (SEBI) is proposing to formulate regulations to regulate crowdfunding. Post the regulations, there will be greater clarity and better directions for investments through crowdfunding in India.

2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e founders-family-friends, angel investments, venture capital investments, private equity)

Investments by strategic investors, private equity funds, and venture capital investors are the most common investors in high growth companies in India. Family and friends of the founders also provide initial capital for the company.

2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?

There is no specific size of investment in a high growth company in India, and the same will vary depending on the activity which the company is engaged in, the level of business projections etc. On an average, the investment size is below USD one (1) million in high growth companies/ start-ups.

2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)

2.3.1 The documentation for an investment may vary depending on the type of transaction which may be a business/ asset purchase, share purchase/ acquisition/ subscription and joint venture.

2.3.2 Typically, any investment proposal, whether a business acquisition or a share acquisition or a joint venture is formulated in a non-binding term sheet, allowing the parties to put on paper the most crucial terms of the investment, yet not binding the parties to such terms (unless specifically provided under the term sheet). A term sheet reflects the commercial understanding between the parties and sets out the initial road map to the proposed transaction in writing. Further, it also aids in laying down the timelines for completion of the transaction.

2.3.3 Upon completion of the due diligence by the investor, binding documents are entered into, which vary depending on the type of transaction being undertaken. In case of a business/ asset transfer, a business transfer/ asset transfer agreement along with ancillary agreements/ documents such as delivery note, novation agreement with customers, vendors, suppliers, service providers will be entered into. In case of a share purchase/ acquisition/ subscription, a share purchase/ subscription agreement and a shareholder's agreement will be entered into. In case of a joint venture, a joint venture agreement setting out the share acquisition mechanism and the rights of the joint venture parties (akin to a shareholder's agreement) will be executed. Additionally, license agreements may be executed in case the foreign investor is also bringing in technology/ intellectual property to the investee company.

2.3.4 As a matter of practice in India, the terms of the shareholder's agreement, specifically in respect of voting rights, management and board structure and restriction on transfer of shares are incorporated in the charter documents of the investee company to be enforceable against the investee company.

2.4 Are there incentive schemes for investing into high growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?

There are no incentive schemes for investing into high growth companies in India, however, incentive schemes may be available for a specific sector such as in case of export oriented companies or companies engaged in the software industry. Such incentive schemes usually grant tax incentives to such companies.

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

Equity shares are preferred by most investors in India, whether international or domestic, as it guarantees voting rights and investment returns, as also convertibles where voting rights are contractually conferred.

3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

3.1 Which company form is most popular? (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)

3.1.1 High growth companies in India are usually formed as private limited companies or closely held /unlisted public limited companies with a view of listing on the stock exchanges at a later stage. Private companies as compared to public companies have less stringent compliance requirements under Indian laws and hence for a growing company, private company form is a preferred option.

3.1.2 Indian laws do not prescribe a mandatory management structure for a private company, other than having a mandatory board of directors. Therefore, such companies are free to appoint chief executives in respect of finance, technology, human resources and operations as required. In high growth companies/ start-ups, the founder of the company generally holds the position of the chairman/ managing director, thereby having control of all main matters of the company.

3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?

Consumer web, e-commerce, healthcare and education are the most preferred sectors by high growth companies.

3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies (e.g accelerators/incubators? Other?)

Under Indian law, a high growth company may be granted a micro, small or medium enterprise status depending on whether the parameters set out in the relevant legislation are met. If a micro, small or medium enterprises status has been obtained by a company, the company has a statutory right to receiving payments from its debtors within forty-five days of acceptance of the service/ goods from the company. Also, certain banks in India have special credit facilities programmes for micro, small and medium enterprises. However, other than the above, there are no specific laws providing specific incentives to high growth companies presently.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

As mentioned earlier, investors would prefer investing by way of equity shares as it will grant the investor voting rights in the company as well as guarantee a return on their investment, as also convertibles where voting rights are contractually conferred.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor

take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

a. Anti-dilution measures

b. Rights of first refusal, pre-emption rights, drag and tag along

c. Protective provisions

d. Information rights

e. Dead-lock resolution

f. Board seats / observer rights

g. Any other terms specific/important in your jurisdiction?

4.1.1 Under foreign exchange regulations in India, the term "control" includes the right to appoint a majority of directors or to control the management or policy decisions including by virtue of their shareholding or management rights or shareholders agreements or voting agreements. Control in case of foreign investments can be of a major concern in such sectors where 100% foreign participation is not permitted.

4.1.2 Anti-dilution measures, transfer restrictions such as rights of first refusal, pre-emption rights, drag and tag along, information rights, dead-lock resolution, board seats/ observer rights, reserved matters/ veto rights are commonly used in transactions in India, to give control/ exits to the investor and for the investor to have a say in the affairs of the investee company. Voting arrangements such as reserve matters and veto rights may be drawn up to cover crucial business and commercial aspects such that the foreign investor can also have a say in such aspects, which he otherwise would not be entitled to if his stake in the investee company is below a certain percentage.

4.1.3 Right of first refusal, pre-emption rights, drag and tag along – Such rights are incorporated in agreements as restrictions on transfer of shares by the shareholders. Until recently, such rights were permitted to be incorporated in respect of investments in private companies only, however pursuant to a recent change in law, inter-se agreements between shareholders on transfer restrictions on shares in case of public companies are also enforceable. Such rights are required to be included in the charter documents of the investee entity.

4.1.4 Protective provisions - In respect of voting rights at meetings of the shareholders and board of directors of the company, parties may agree to include reserve matters, which will require the approval of both parties. This protects the right of investors who are not in majority in the company, as such minority investors will also have a say in the reserve matters when such matters are taken up at a meeting of the company.

4.1.5 Information rights – Information rights are included for investments and involve giving information regarding the financial and operational standing of the company periodically.

4.1.6 Dead-lock resolution – Rights such as exit rights/ call/ put rights at a discount/ premium respectively, right to sell the existing stake, referral of the matter to arbitration are common as dead-lock resolution mechanisms.

4.1.7 Board seats/ observer rights – Depending on the level of investment, an investor may be granted either a board seat or observer rights/ representation at board meetings of the company.

5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

The following exit strategies are the most commonly used in investments in high growth companies in India:

5.1.1 Initial Public Offer (IPO) - The investor will be entitled to offer its shares for sale to public. As the use of an IPO as an exit strategy depends on market conditions very few exits are by way of an IPO in recent times. Also, an IPO as an exit strategy is time-consuming and involves compliance with the procedures set out by SEBI in respect of public offerings.

5.1.2 Put option/ drag along right/ tag along rights - Requiring the company or the promoters to purchase the shares held by the investor. A put option cannot be implemented at a pre-agreed price, however the exit route is less procedural.

5.1.3 Buy-Back – The investee company undertakes a selective buy-back of shares held by the investor. Although not time consuming, the buy-back procedure is required to comply with the requirements set out in the Companies Act, 1956 and the guidelines set out by SEBI (for public listed companies).

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?

5.2.1 Issues concerning valuation and exit options are usually dealt with during negotiations with all parties. Exit options such as put options are included in shareholders' agreements, despite concerns being raised by various authorities, as there was no finality on such clauses. Initial investment and shareholders' agreement are usually followed in the next round of investments, however, the shareholder rights may be re-negotiated depending on the change in shareholding.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?

6.1.1 Presently, there are no specific tax benefits can be availed by a high growth company in India. Tax law provisions and rates apply uniformly to all companies, including for a high growth company/ start up.

6.1.2 Having said that, if the high growth company/ start up is located in a Special Economic Zone (SEZ), tax benefits can be availed in the first fifteen (15) years of its incorporation subject to fulfilment of certain conditions.

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.

6.2.1 Under the Foreign Direct Investment Policy of India, there are several sectors which are presently prohibited from 100% foreign participation such as telecommunications (allowing upto 74% foreign participation), multi-brand retail (allowing upto 51% foreign participation), insurance (allowing upto 26% foreign participation) and defence (allowing upto 26% foreign participation except if the investment ensures access to modern and state of the art technology). Foreign investment in such sectors can be challenging especially when technology is being provided by the foreign investor for a capped participation.

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).

7.1.1 Anti-bribery – From the perspective of foreign investors specifically from the United States of America, past non-compliances by the investee entity or its officers with anti-bribery laws can be of a major concern. Given that prevailing anti-bribery laws in India are not as stringent as compared to anti-bribery laws in many other jurisdictions, Indian companies have a lower level of awareness and compliance about anti-bribery.

7.1.2 Competition – Acquisitions which result in permissible threshold limits on assets/ turnover being exceeded will require prior approval from the Competition Commission of India.