MERGERS & ACQUISITIONS (M&A) IN INDIAN TELECOM INDUSTRY- A STUDY

Mergers and Acquisitions (M&A) are strategic tools in the hands of management to achieve greater efficiency by exploiting synergies and growth opportunities. Mergers are motivated by desire to grow inorganically at a fast pace, quickly grab market share and achieve economies of scale.

India has become a hotbed of telecom mergers and acquisitions in the last decade. Foreign investors and telecom majors look at India as one of the fastest growing telecom markets in the world. Sweeping reforms introduced by successive Governments over the last decade have dramatically changed the face of the telecommunication industry. The mobile sector has achieved a teledensity of 14% by July 2006 which has been aided by a bouquet of factors like aggressive foreign investment, regulatory support, lower tariffs and falling network cost and handset prices.

M&A have also been driven by the development of new telecommunication technologies. The deregulation of the industry tempts telecom firms (telcos) to provide bundled products and services, especially with the ongoing convergence of the telecom and cable industries. The acquisition of additional products and services has thus become a profitable move for telecom providers.

REGULATORY FRAMEWORK

M&A in telecom Industry are subject to various statutory guidelines and Industry specific provisions e.g. Companies Act, 1956; Income Tax Act, 1961; Competition Act, 2002; MRTP Act; Indian Telegraph Act; FEMA Act; FEMA regulations; SEBI Takeover regulation; etc. We will cover some of these regulations hereunder which are unique to the telecom industry.

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TRAI Recommendations

Telecom Regulatory Authority of India (TRAI) is of the view that while on one hand mergers encourage efficiencies of scope and scale and hence are desirable, care has to be taken that monopolies do not emerge as a consequence. TRAI had issued its recommendation to DoT in January 2004 regarding intra circle Mergers & Acquisitions which were accepted by DoT and stated below.

DoT Guidelines

Department of Telecommunications (DoT) can be credited with issuing a series of liberalising initiatives in telecom sector which has led to phenomenal growth of the Industry. Based on recommendations of TRAI, DoT issued guidelines on merger of licences in February 2004. The important provisions are state below:

- Prior approval of the Department of Telecommunications will be necessary for merger of the licence.
- The findings of the Department of Telecommunications would normally be given in a period of about four weeks from the date of submission of application.
- Merger of licences shall be restricted to the same service area.
- There should be minimum 3 operators in a service area for that service, consequent upon such merger.
- Any merger, acquisition or restructuring, leading to a monopoly market situation in

the given service area, shall not be permitted. Monopoly market situation is defined as market share of 67% or above of total subscriber base within a given service area, as on the last day of previous month. For this purpose, the market will be classified as fixed and mobile separately. The category of fixed subscribers shall include wire-line subscribers and fixed wireless subscribers.

- Consequent upon the merger of licences, the merged entity shall be entitled to the total amount of spectrum held by the merging entities, subject to the condition that after merger, the amount of spectrum shall not exceed 15 MHz per operator per service area for Metros and category 'A' service areas, and 12.4 MHz per operator per service area in category 'B' and category 'C' service areas.
- In case the merged entity becomes a "Significant Market Power" (SMP) post merger, then the extant rules & regulations applicable to SMPs would also apply to the merged entity. TRAI has already classified SMP as an operator having market share greater or equal to 30% of the relevant market.

In addition to M&A guidelines, DoT has also issued guidelines on foreign equity participations and management control of telecom companies. The National Telecom Policy, 1994 (NTP 94) provided guidelines on foreign equity participation and as revised by NTP 99 permitted maximum 49% cap on foreign investment. Recently by its order no. - 842-585/2005-VAS/9 dated 1st February, 2006 DoT has enhanced the FDI limit in telecom sector to 74%. The key provisions of these guidelines are as follows:

- The total composite foreign holding including but not limited to investments by Foreign Institutional Investors (FIIs), Non-resident Indians (NRIs), Foreign Currency Convertible Bonds (FCCBs), American Depository Receipts (ADRs), Global Depository Receipts (GDRs), convertible preference shares, proportionate foreign investment in Indian promoters/investment companies including their holding companies, etc., referred as FDI, should not exceed 74%. The 74% investment can be made directly or indirectly in the operating company or through a holding company and the remaining 26 per cent will be owned by resident Indian citizens or an Indian Company (i.e. foreign direct investment does not exceed 49 percent and the management is with the Indian owners). It is also clarified that proportionate foreign component of such an Indian Company will also be counted towards the ceiling of 74%. However, foreign component in the total holding of Indian public sector banks and Indian public sector financial institutions will be treated as 'Indian' holding.
- The licencee will be required to disclose the status of such foreign holding and certify that the foreign investment is within the ceiling of 74% on a half yearly basis.
- The majority Directors on the Board including Chairman, Managing Director and Chief Executive Officer (CEO) shall be resident Indian citizens. The appointment to these positions from among resident Indian citizens shall be made in consultation with serious Indian investors.
- The merger of Indian companies may be permitted as long as competition is not compromised as defined below:

"No single company/legal person, either directly or through its associates, shall have substantial equity holding in more than one licencee Company in the same service area for the Access Services namely; Basic, Cellular and Unified Access Service. 'Substantial equity' herein will mean equity of 10% or more'. A promoter company/Legal person cannot have stakes in more than one LICENCEE Company for the same service area" Some exceptions have been provided to this guideline.

- The Licencee shall also ensure that any change in shareholding shall be subject to

all necessary statutory requirements.

As per recent news reports, the Government wants to arm itself with power to block FDI in case the investment from companies or countries deemed undesirable, even if it is within the approved limit. This is a positive step due to increasing security concern India is facing but has led to apprehension that the new law will be used to block investment from certain parts of the world.

FEMA Guidelines

The foreign exchange laws relating to issuance and allotment of shares to foreign entities are contained in The Foreign Exchange Management (Transfer or Issue of Security by a person residing out of India) Regulation, 2000 issued by RBI vide GSR no. 406(E) dated 3rd May, 2000. These regulations provide general guidelines on issuance of shares or securities by an Indian entity to a person residing outside India or recording in its books any transfer of security from or to such person.

RBI has issued detailed guidelines on foreign investment in India vide "Foreign Direct Investment Scheme" contained in Schedule 1 of said regulation. As per the FDI scheme, investment in telecom sector by foreign investors is permitted under the automatic route within the overall sectoral cap of 74% without RBI approval. The salient features of FDI scheme as applicable to telecom sector is as follows:

- Industries which do not fall within the ambit of Annexure A can issue shares under automatic route to foreign companies (Para 2). Since telecom sector is not listed in Annexure A hence foreign investment can be made in telecom sector upto 74% cap without prior approval of RBI.
- In case, investment by foreign investor(s) in an Indian telco is likely to exceed sectoral cap of 74%, then they should seek approval of (FIPB) Foreign Investment Proposal Board. (Para 3)
- FDI scheme permits automatic approval of transfer of shares from one foreign shareholder to another, so long as the transfer is in compliance of FDI scheme and the regulation. (Regulation 9)
- However, if the shares are being transferred by a person residing outside India to a person resident in India, it shall be subject to adherence to pricing guidelines, documentation and reporting requirements of RBI. Application seeking RBI approval is to be made in Form TS 1. (Regulation 10 B)
- The issue price of share should be worked out as per SEBI guidelines in case of listed companies. In case of unlisted companies, fair valuation method as prescribed by erstwhile Controller of Capital Issues should be adopted and should be certified by a Chartered Accountant. (Para 5)
- FDI scheme also stipulates the norms on dividend balancing, whereby the cumulative amount of outflow on account of dividend for a period of 7 years from commencement of production or services should not exceed cumulative amount of export earning during those years. The dividend balancing guidelines are applicable to companies included in Annexure E of FDI scheme and telecom industry is not included in said annexure. (Para 6)
- In case preference shares are issued to a foreign investor, the rate of dividend shall not exceed 300 basis points over the Prime lending rate of SBI, prevailing on the date of Board meeting where such issuance is recommended. (Para 7)
- The reporting requirement are contained in regulation 9 viz. a) The Indian company should report the details of receipt of consideration to RBI within 30 days of receipt and b) The Indian company should submit report of issuance and allotment of shares in Form FCGPR along with necessary certificates from the Company Secretary and the Statutory Auditor of the Company.
- An Indian Company may also issue shares on Rights basis or issue bonus shares

(Regulation 6A); subject to compliance of conditions of FDI scheme and sectoral cap.

- FDI scheme prohibits investments by citizen or entities of Pakistan and Bangladesh (regulation 5) primarily on security concerns. In the recent past, DoT has also delayed its approval to an Egyptian company's investment in Hutch India on similar grounds.

SEBI Takeover Guidelines

SEBI takeover guidelines called Securities and Exchange Board of India (Substantial acquisition of shares and takeover) Regulations, 1997 are applicable to listed Public companies and hence would be applicable in case of M&A in listed telecom companies like Bharti, Reliance Communication, Shyam Telecom, VSNL, Tata Teleservices (Maharashtra) Limited, etc. These guidelines have been recently amended by SEBI and notified vide SO No. 807(E) dated 26.05.2006.

The highlights of the amendment are as follows:

- No acquirer who together with persons acting in concert with him, who holds 55% or more but less than 75% of the shares or voting rights of the target company shall acquire by himself or through persons acting in concert unless he makes a public announcement as per the regulations. Further, if a target company was unlisted, but has obtained listing of 10% of issue size, then the limit of 75% will be increased to 90%. Regulation 11(2)
- If an acquirer who together with persons acting in concert with him, who holds 55% or more but less than 75% of the shares or voting rights of the target company is desirous of consolidating his holding while ensuring that Public Holding in the target company does not fall below the permitted level of listing agreement he may do so only by making a public announcement as per the regulations. Further, if a target company was unlisted, but has obtained listing of 10% of issue size, then the limit of 75% will be increased to 90%. - Regulation 11(2A)
- The minimum size of public offer to be made under Regulation 11(2A) shall be lesser of a) 20% of the voting capital of the company; or b) such other lesser percentage of voting capital as would enable the acquirer to increase his holding to the maximum possible level, while ensuring the requirement of minimum public shareholding as per listing agreement.

Competition Laws

Competition Commission of India (CCI), established in 2003, holds statutory responsibility for ensuring free and fair competition in all sectors of the economy. The Competition Act, 2002 has provided for a liberal regime for mergers, whereby combinations exceeding the threshold limits fall within the jurisdiction of CCI. The threshold limits are quite high.

Most competition laws in the world require mandatory prior notification of every merger to the competition authority but under Indian law it is voluntary. However CCI can also take suo motu cognisance of a merger perceived as potentially anti competitive and it can also enquire until one year after the merger has taken place. Once CCI has been notified, it must decide within 90 days of publication of details of the merger or else it is deemed approved. The CCI can allow or disallow a merger or can allow it with certain modification. Most of the operative provisions of Competition Act have still not been notified.

THE CONTOURS OF M&A IN TELECOM

M&A are also referred as Corporate Marriages and Alliances. Mergers can be across same or similar product lines. In many cases mergers are initiated to acquire a competing or complementary product. A reverse merger is another scenario in taxation parlance where a profit making company merges with a loss incurring company to take advantage of tax

shelter.

A horizontal merger (mergers across same product profile) adds to size but the chances for attainment of profit efficiency are not very high. On the other hand a vertical merger (entities with different product profiles) may help in optimal achievement of profit efficiency. Say a mobile operator acquires a national long distance company and thus saves IUC charges. In telecom Industry, most of the acquisitions were horizontal which helped the acquirers to expand the area of their operation and customer base quickly. These provided economies of scale with phenomenal benefit to the acquirers in terms of higher profitability, and better valuations.

Takeovers generally have three typical patterns:

a) In the first model, the investor acquires a controlling stake in the acquired company and retains it as a separate entity. This is the simplest model with the intent to avoid the legal hurdle for merging the company into the parent company. This route also gives the acquirer a flexibility to sell off the operation on a stand alone basis later on, in case the merger is not successful. This mode has been followed by Hutchison, which has retained most of the acquired companies (Usha Martin- Kolkata, Fascel- Gujarat, Aircel Digilink – Haryana, Rajasthan and UP East, Sterling Cellular- Delhi, Escotel - Punjab) as separate legal entities.

b) In the second model, the acquirer merges the acquired company with the parent after acquiring controlling stake. This model requires completion of merger formalities with due approval of High courts and also from DoT. It has the advantage of avoiding statutory compliance for several entities and integrate all operations seamlessly into a single legal entity. This model has been followed by Bharti, which has merged most of the acquired entities with the parent in due course of time.

c) The third model entails purchase of assets of the target company on stand alone basis without purchasing the company as a whole. In some cases, where the licences were cancelled by DoT due to default, such companies sold the telecom assets and customer database to the acquirer, who could easily integrate the same into his existing licence and strengthened his network and customer base at a nominal cost. The seller company which was stripped of licence as well as telecom network was ultimately wound off.

THE ALLURE OF M&A IN TELECOM

India's telecom liberalisation was noticed by Global investors in 1995 when the Government permitted entry of foreign telecom operators through Joint venture route. Some of these global giants included Vodaphone, AT&T, Hutchison Whampoa, Telekom Malaysia, and Telestra Australia. We now need to understand some of the predominant objective of takeovers in telecom sector, which can be summarised as follows:

- Acquisition of licences or geographical territory;
- Acquisition of spectrum;
- Acquisition of telecom infrastructure and network;
- Acquisition of customer base to achieve an economic base;
- Acquisition of brand value;
- Higher operating profit (EBITDA) margin;
- A combination of above.

Market access: There has been almost saturation of demand in the home market of majority of foreign investors where teledensity ranges from 40% to 100%. On the other hand, the teledensity in Indian market is currently hovering at 14% like a low hanging fruit. The rural teledensity is almost negligible at about 3%. India's young and middle class market offers tremendous scope for market expansion and new business. For example, even after 15 years

of economic reforms, sale of most consumer durable goods has not exceeded Rs. 60 million, whereas telephone penetration has already crossed the Rs. 120 million mark and is all set to cross 150 million mark by December 2006 and Rs. 250 million mark by 2010. This huge expansion is possible only with higher focus on rural telephony, bridging the digital divide and higher allocation of network and funds to rural areas which are not so rewarding in terms of ARPU.

Spectrum: Spectrum is turning out to be the biggest bottleneck for Indian mobile operators as they face network problems, poor voice quality and call dropping. GSM operators initially get 4.4 MHz of spectrum while CDMA operators get 2.5 MHz spectrum. In case of GSM operators with 10 lakh or more subscribers, they are eligible for 10 MHz spectrum, while CDMA operators get 5 MHz for 10 lakh subscribers. Since CDMA technology carries the voice in small packets, it can carry about five times more traffic and hence has a lower spectrum allocation.

However, as the number of mobile users is growing at an amazing rate of 4 million per month), spectrum is falling short of requirements. Thus, the foreign investors prefer to acquire an existing operation to ensure ready availability of spectrum, instead of applying for a new licence where spectrum allocation from DoT is really a challenging task. The Government is also taking effective steps to get approx 40 MHz spectrum vacated from Indian defense services which will give a fresh lease of life to spectrum starved market. This will be a key driver for all future M&A in India.

Network roll out: Network roll out is a nightmare for telecom operators. It is more complex for a foreign operator who may not be conversant with local conditions. Network roll out involves Right of way (ROW) approvals, coordination with local government departments, acquiring BTS and BSC sites on rentals, acquiring municipal and local approvals to set up tower and antenna, obtaining electrical connection for the sites, import of equipment, installation of tower, equipment and shelter, SACFA and TEC approvals, integration of various sites and final launch of services in a geographical area etc. Generally the time to roll out a network in a circle takes minimum 6 months to 1-year time. The industry is also resorting to site and infrastructure sharing with other operators to reduce its capital expenses and operating expenses cost and optimise profitability.

Human Resource: The dovetailing of human resources of the acquired company into the culture of parent company has significant importance in any M&A deal and can even spoil a deal if not properly managed. It is now an established principle that local leaders decide the success or failure of a cross boarder deal. The savvy acquirer retains competent local leaders and dangles incentives and awards to align their personal interest with that of the merged entity. Premium is placed for target companies which have strong management team in place, lower manpower base and higher employee productivity. Some benchmarks used in this regard are – Number of customers per employee, Revenue per employee per month etc. Majority of the telecom companies resort to outsourcing of routine and non core activities and reduce number of "on roll employee" to attract better valuations. Hence, it is essential to make an assessment of the off roll and outsourced staff involved in a telecom operation to ascertain the true operational efficiency and real manpower cost.

Brand value: In most cases, where the acquisition is for majority control, the foreign investor is likely to introduce its own brand in India instead of local brand. Hence, generally no value is placed on brand related expenditure amortised or any goodwill. However, where the investor takes minority stake and the brand stabilised by the controlling local partners has become popular, brand value plays an important role in valuation.

Better margin possibility: Across Asia-Pacific, be it China, Indonesia, Philippines, Thailand or Australia, operating margins (EBITDA) average 40% - 60%, which are considerably higher than the mid-30% for Indian telecom operators. The EBITDA margin of Bharti Airtel at 37% is the highest among all telecom operators whereas for other operators it ranges from 11% to 25%. Thus, the scope for enhancing margins is fairly

significant in Indian market since Government levies, licence fees, etc. are likely to come down to give further fillip to teledensity. The Government is also providing Universal Service Obligation (USO) support to operators to expand their network in rural areas.

The foreign investors continue to look at India to spread their market. In the initial years, the number of operators in each circle were limited to four which was a major entry barrier. Further the entry fee for acquiring a licence was also high. But over the years, the DoT has been consistently liberalising entry norms and making market access easier for foreign investors with the ultimate objective of benefiting consumers.

THE VALUATION OF A TELECOM LICENCE

George Bernard Shaw had once said, "Economists know the price of everything, but the value of nothing." This saying is aptly reflected in case of telecom valuation also. The acquirer pays hefty valuation to acquire an entity and the "Business value" placed is much higher than "Accounting value".

The local promoters strive hard to enhance the enterprise value of their project by adopting a multi pronged strategy. This involves a careful incubation of network across the entire circle, hiring a strong management team, installing robust billing system, well oiled channel partner network and above all, an aggressive selling strategy to build a critical mass of customer base. In their aggression to inflate enterprise value, some operators end up creating "phantom subscribers" to attract better valuation. Phantom subscribers refer to low value prepaid cards, which are sold by channel partners to unwilling end users. These cards are not likely to yield much revenue to the operator, but just retained as customers to show an inflated subscriber base and fetch higher valuations.

The Investment banker has to decide what is being valued – a) Whether its a valuation of company's equity or its assets; b) Whether the company is being valued as a going concern with all its assets and liabilities or is under liquidation; or c) Is it a valuation of minority interest or a Controlling stake; d) Whether the valuation of entity on per sub base is appropriate; e) Whether the EV/EBITDA ratio is in line with Industry trend. The list of these factors is endless.

Enterprise value (EV) refers to the market capitalisation of a company plus debts. When an investor acquires a company, it takes over not only the assets of the company, but also assumes the liability to pay the existing debts and liabilities of the company. Thus, Enterprise value is the sum total of all fair value of assets and the liabilities of the acquired entity. The key performance metrics to evaluate the EV are:

a) **EV / EBITDA ratio**: This ratio reflects number of years the unit has to yield operating profit (EBITDA) to return the basic investment made by the Investor. This ratio is in the nature of PE ratio from the viewpoint of a retail investor and varies from Industry to industry. In telecom Industry, most of the deals struck in the past couple of years have been at EV/EDITDA ratio of 6-10 times.

b) **EV/Revenue Ratio:** This ratio indicates number of years required to generate revenue to return the investment price paid by the acquirer. In one way it can be likened to pay-back period. EV/Revenue ratio is on an average five or less.

c) **Per subscriber EV (EV/number of acquired subscribers)**: This ratio represents value placed by the acquirer on subscribers acquired along with complete network and infrastructure. Smart acquirers on the lookout prefer to pay a premium for taking over an existing operation say US$ 450 per subscriber as against network rollout which costs even less than 1/3rd cost @ US$ 100. As we would see later, the per subscriber rate varies from US$ 400 to US$ 1000. A company earning higher Average Revenue Per User (ARPU) is likely to command better per subscriber rate. A better rate is also dependent on other factors like Churn ratio, VAS revenue, type of circle, average life cycle of customer, subscriber acquisition cost, quality of customers etc. An indicative

Enterprise value can also be computed by multiplying the subscriber base of the company with the per subscriber rate. For example, if the subscriber base of a telecom operator is 1,00,000 customers and the applicable per subscriber rate for this category of operator is US$ 400, then the indicative enterprise value will be US$ 40,000,000 (US$ Forty million).

M&A – CASE STUDIES

The first M&A deal in India was the sale of Mumbai licence by Max group to Hutchison Whampoa group of Hong Kong. The deal fetched over half a billion dollars for Max group and was touted as a major success for Indian entrepreneur in telecom venture. This followed a series of M&A in subsequent years as stated hereunder. Some of the other high profile deals were Vodaphone's acquisition of 10% equity in Bharti in 2006 for US$ 1 billion, Maxis acquisition of Aircel at enterprise value of US$ 1 Billion, Birla Group's acquisition of Tata's stake in Idea Cellular.

Interestingly some of the high profile investors who had sold their stake around year 2000 are now reentering India like Telekom Malaysia (exited India in 2000 from Kolkata licence and recently acquired 49% stake in Spice Telecom) and Vodafone (exited India in 2003 from RPG Cellular Chennai and recently acquired stake in Bharti).

The author also closely followed the sell-off, acquisition, resale and reacquisition by Indian Promoters as a case study. In April 1998, Max group had sold its stake in Mumbai licence to Hutchison Telecom for US$ 560 million. Somewhere along the way Max group again picked up a small stake of 3.16% in Hutch and resold it to Essar Group in October 2005 for US$ 147 million. Max India has staged another comeback in Hutch by acquiring an 8.33% from Kotak Mahindra Bank for Rs. 1,019 crore in 2006. This second return to the telecom business reflects the buoyant conditions in telecom sector.

The table on the next page gives a bird's eye view of major M&A deals in India and the key indicators like per sub value, enterprise value etc.

The valuation of state owned Bharat Sanchar Nigam Limited (BSNL) is estimated to be US$ 30 Billion one of the highest in India. On a global scale, China Mobile has emerged as the world's most highly valued telco with enterprise value of US$ 131.46 billion, followed by Vodaphone at US$ 123.11 billion as on July 2006.

From the table, readers can find that average valuation per subscriber ranges from US$ 400 to US$ 550 which in turn is based on a variety of factors including Average ARPU, type of circle, competition in the circle, Category of operator—whether only a Mobile service provider or an integrated telecom player (like Bharti and Reliance) etc. Valuation is generally lower in case the acquirer takes a minority stake as against controlling stake. Similarly, valuation also suffers if the target company is not listed and hence has lower liquidity (as in case of Idea, Hutch etc). As a thumb rule, suggested by one economist, the differential for non liquidity of non listed entity could be as high as 20% -25%.

While most of the GSM operators resorted to M&A in order to achieve growth, Reliance Infocomm did not go for inorganic route and instead rolled out a green field project. This was also due to the fact that Reliance had adopted CDMA technology and was able to roll out the network at much lower cost as compared to GSM network.

DUE DILIGENCE AND DIAGNOSIS

The due diligence exercise gives the investor a deep insight into financial and operational issues of the target company. If these issues are not properly analysed, it can lead to serious integration issues, while by that time the merchant bankers who have assisted in the acquisition may have left the scene. Some of these due diligence areas are:

Strategic and Business due diligence: This includes careful analysis of current market share, planned market share, quality of existing customer base, revenue mix, average ARPU in the service area, per minute revenue (RPM), review of marketing strategy, customer care philosophy, ability of existing channel partners to promote

Major M&A deals in Indian telecom sector

Company/Service Name	% Stake sold	Buyer	Seller	Year	Deal size (US$)	Indicative Enterprise value (US$)	Per sub value (US$)
Orange, Mumbai	41%	Hutchison Group, Hong Kong	Max Group, Delhi	1998	560 Mn	1.36 Bln	NA
Hutch, India	8.33%	Max India	Kotak Mahindra, India	2006	225 Mn	-	NA
Hutch Essar, India	5.1%	Hutchison Group, Hong Kong	Hinduja	2006	450 Mn	9 Bln	NA
Hutch Essar	3.17%	Essar Group	Max India	2005	146 Mln	-	570
Command Cellular, Kolkata	100%	Hutchison & Indian Group,	Usha Martin & Others	2000	-	138 Mln	
Idea Cellular	48.14%	Aditya Birla Group	Tata Group	2005	NA	2 Bln	400
Modi Telestra, Calcutta	100%	Bharti Group, India	B.K.Modi and Telestra	2000	NA	160 Mln	
Bharti	9.3%	Private Investors	Warburg Pincus	NA	873 Mn	NA	1000
Bharti Airtel	10%	Vodaphone	Bharti Group	2005	1.5 bln	16 Bln	1000
Aircel, Chennai	79.24%	Sterling Group, Chennai	RPG Group	2003	210 Cr		
Aircel, TN, Chennai and NE	74%	Maxis, Malaysia	Sterling Group	2006	750 Mn	1.07 Bln	496
Spice, (Punjab and Bangalore)	49%	Telekom Malaysia, Malaysia	NA	2006	178 Mn	363 Mln	-
Reliance CDMA	-	Qualcomm, San Diego, US	Reliance Infocomm	2002	-	10 Bln	-
BPL Mobile and BPL Cellular	-	Promoters		2005	1.15 Bln	NA	-

the services and withstand competition, reason for low performance of the target company, synergies which are likely to be enjoyed on acquisition, likelihood of entry of new competitors in the licenced area, strategic initiatives needed to establish market leadership etc.

Technological & Integration issues: The technical due diligence includes review of technical aspects, telecom network technology adopted etc. This helps the investor to find out the quality of network assets, whether the coverage is adequate or not, their maintenance and upgrade status, status of integration of various systems like switch, non compatibility of existing network equipment if any with the current system of acquirer resulting their obsolescence and write offs, value added services, billing system (Whether the billing system can be interfaced with the system of acquirer, the upgrade status of billing system, does it interface with financial systems), customer care system (database structure in customer care system, its interface with switch for seamless flow of data on activation through front end, customer grievance resolution mechanism, ease of customer interaction from call centre, reporting mechanism for pending customer queries and its escalation), IT system, order fulfillment process, etc.

Financial & Commercial due diligence: The financial due diligence is likely to give deep insight into operations, which otherwise would not be possible. Some key issues to be analysed under this head would include: accounting policies on intangibles and deferment, contingent liabilities disclosed and undisclosed, statutory and workmen dues, finance cost and possibility of debt restructuring, capital structure, vendor and other dues and reason for delayed or non payment, list of all contracts and agreements and the review of all rates and terms, possibility of renegotiation of major commercial agreements and quantification of possible saving, details of

pending export obligations under EPCG rules, details of bank guarantees issued, pending cost saving measures initiated in the company, internal control measures and processes, internal audit reports, fixed assets verification reports, valuation reports if any, etc.

Secretarial & Legal due diligence: The acquirer also carries a detailed legal due diligence of the various approvals obtained by the target company to understand possible instances of violations if any and the quality of statutory compliances. This includes a review of statutory approvals required, approvals taken and their renewal status, Minute books of AGM, EGM, Board and committee meetings, review of shareholders agreement, Memorandum and Articles, statutory clearances for all investments made till date, review of all major agreements (with lessors for BTS/BSC/MSC sites, collection and recovery agents, channel partner agreement, roaming agreements, network services providers, VAS services, DoT licence agreement), listing of all legal cases filed by and against the company and current status, list of statutory compliances, list of all statutory liabilities (status of payment of various dues like PF, ESI, licence and spectrum charges, interconnect payments, liquidated damages if any levied by licensor), list of all IPR rights, IPR violation issues etc).

Human Resource issues: The investor analyses the average salary of the employees, ratio of outsourced employee to total employees, salary range vis a vis Industry trend and chances of salary increase to be made. The investor also tries to find out whether any Golden Parachute has been issued to senior management which has to be borne by the merged entity.

The results of due diligence exercise help to unearth startling facts and assist the investment banker to revise the valuation. From the acquirer's perspective, some change management problems can be avoided by solving them before the deal closes. For example, if the due diligence reveals that the workforce of the target company is inflated, then he may insist for its rationalisation as a precondition to deal closure.

WHETHER M&A IN INDIAN TELECOM WERE SUCCESSFUL

A merger to be successful should create new capabilities, offer better value proposition to the combined entity's customers and above all enhance shareholders' value. Empirical studies prove that M&A brings with it the advantage of synergies to the operators and in majority of cases results in immense increase of shareholders value. M&A in Indian telecom industry has also benefited other stakeholders i.e. customers, Indian economy and society at large.

M&A have acted as catalyst to stupendous growth in teledensity to 14% in 10 years (1995 -2006), as against 2% in 48 years (1947-1994) of independence. According to a study conducted by the reputed international agency, OVUM on "The economic benefits of mobile services in India" on behalf of Cellular Operators' Association of India, it was found that mobile sector has generated 3.6 million jobs directly or indirectly and the same will rise by at least 30%. Similarly the Mobile industry contributes over Rs. 145 billion per annum by licence fees, spectrum fees, import duties, taxes, etc. Taking the OVUM findings on the base of 48 million subscribers in January 2005, COAI has estimated that at a mobile subscribers base of 200 million in 2007, the industry would contribute over 10 million jobs and over Rs. 500 billion annual revenue to the Government.

From foreign investors' perspective, they have immensely gained from investing in India. As per recent news, out of Hutchison's total global revenue of Rs. 13440 crores, over 45% comes from India which is no mean achievement. Indian promoters who commenced their telecom operation on a small scale in few circles, gained immensely on sale of their stake to foreign investors. In fact, some of the world's largest telecom companies, who have left India with a bitter experience a few years ago like British Telecom, Vodaphone, France Telecom, Telekom Malaysia, Telestra Australia are all set to return even as minority shareholders on witnessing telecom success story.

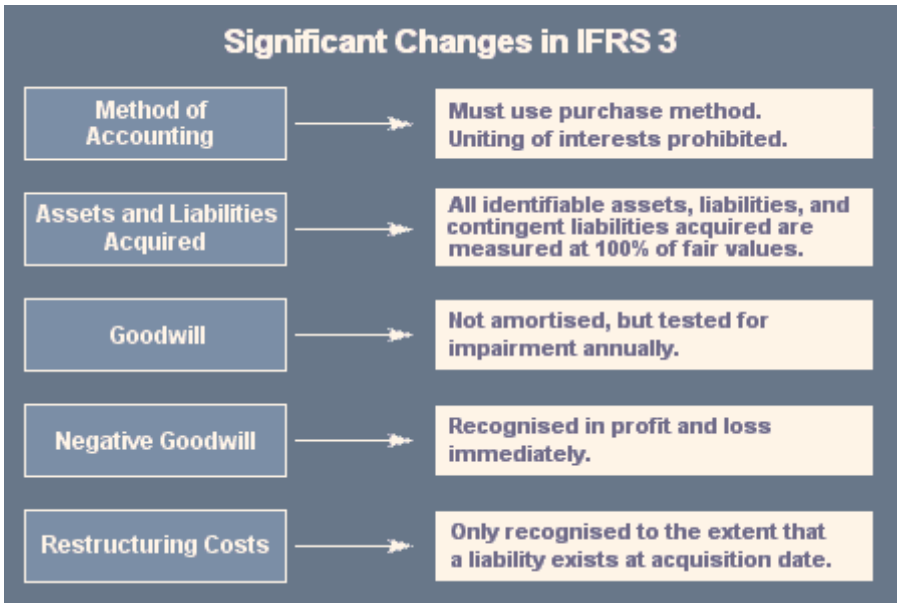
ACCOUNTING ISSUES

The accounting issues arising in any M&A include merger accounting by the acquirer, treatment of goodwill and reserves of the acquired company, treatment of Goodwill/capital reserve arising on M&A, choice of the method of accounting – pooling of interest or purchase method, accounting for share of profits/losses and dividends for investments made in Indian operating company.

Accounting Standard 14 classifies amalgamations (also referred as business combination) into two categories for the purpose of accounting a) amalgamation in the nature of merger and b) amalgamation in the nature of purchase. AS 14 provides that in case of amalgamation in the nature of merger, pooling of interest method is to be applied, whereas for other cases purchase method is to be applied. This standard is applicable only if two or more entities are merged to form a new entity. In case of takeover of majority interest which does not yield to formation of a new merged entity, AS 14 is not applicable.

In order to apply pooling of interest method (in case of merger scenario) five conditions have to be fulfilled i.e. a) transfer of all assets and liabilities to transferee company b) 90% of shareholders of transferor company should become shareholder of transferee company c) Consideration for purchase should be paid by issue of equity share of transferee company d) Continuation of business of the acquired company and e) No adjustment to be made for assets and liability taken over. Since in most of the telecom acquisitions, conditions No. (B) and (C) are generally not applicable, the purchase method is applied for takeovers.

IFRS 3 prohibits pooling of interest method and permits only purchase method of accounting by the acquirer in M&A. With issuance of IFRS 3, IAS 22 stands withdrawn. The significant changes introduced by IFRS 3 are as follows:



In June, 2001, the US Financial Accounting Standards Board (FASB) adopted two new accounting standards: FAS 141 'Business Combinations' and FAS 142 'Goodwill and Other Intangibles' which was applicable for business combinations from 1 July 2001. These introduced major changes in US accounting as follows:

- a ban on pooling (i.e. merger accounting); all business combinations are to be treated as purchases (i.e. acquisitions);
- no amortisation of goodwill and
- in most cases, annual testing for goodwill impairment testing rather than amortisation, for acquired intangible assets with indefinite lives.

Takeovers in Indian telecom industry have seen following common accounting and financial issues:

- In telecom acquisitions, goodwill is stated at cost/book value less accumulated

amortisation and is amortised on straight-line basis over the remaining period of service licence of the acquired company from the date of acquisition. For example, say A Limited acquired B Limited at a purchase consideration of US$ 1.5 billion, as against the book value of US$ 1 billion on 1st August 2006. The licence of B Ltd is expiring on 30th July 2016. In this case, US$ 500 million is the goodwill in the books of A Limited and will be amortised over next 10 years being the balance period of licence of B, on SLM basis,

- In case of change of brand and launch of "superior" brand, the existing brand related amortised expenses and goodwill are written off fully. For example, when Hutchison finally decided to introduce Hutch Brand on consolidation of its operations across India, it had to write off all the local brands like Orange, Fascel, Command etc which were amortised earlier.
- Major write off of debts is also seen. For example, upon demerger of Reliance Infocomm from Reliance Industries Limited, over US$ 1 billion were written off from the Balance Sheet which included; *inter alia,* bad debts, receivable etc.
- Change in key accounting policies of acquired unit in line with the acquirer's accounting policies, like revenue recognition, treatment of licence fee payment, debtors provisioning, treatment of activation revenue.
- In many cases, the new operators also junk the existing billing system leading to major write off.
- Intelligent network (IN) system is the heart for credit monitoring and management of prepaid services. In some cases, IN system of a preferred vendor is installed leading to junking of existing IN system and its resultant write off.

TAXATION

Following are the major taxation issues in any M&A deals including telecom sector:

1) Carry forward of losses of the acquired company.
2) Capital gains on sale of shares by Indian shareholders.
3) Capital gains on sale of shares by foreign shareholders.

Carry forward of losses:

The Income Tax law relating to carry forward of losses are contained in Section 72, 72A and Section 79 of the Income Tax Act, 1961. While Section 72 provides timeline for carry forward of losses, Section 79 stipulated conditions for carrying forward of losses.

Section 79 provides that in case of company in which public are not substantially interested, no loss incurred in any prior previous year shall be carried forward and set off against losses of the previous year unless shares carrying 51% or more of voting rights are held beneficially by same set of shareholders on last date of financial year as compared to previous year(s) in which losses were incurred. The exception provided are a) Change in voting power due to death of shareholder or arising out of gift to any relative and b) Change in shareholding of an Indian subsidiary of a foreign company arising due to amalgamation or demerger of foreign company.

Majority of M&A in telecom sector were in respect of closely held companies, in which public were not substantially interested and hence 51% beneficial shareholding was attracted. In most cases of telecom acquisitions, the control was obtained by investing at indirect level and altering direct holding as to a minimum avoidable level. This was achieved by changing shareholding at a level above the direct holding level, so that at least 51% direct beneficial holding continued.

Capital gains

The capital gains arising from transfer of shares is liable to taxation under the Income Tax Act depending upon the nature of gain, whether it is long term or short term.

Section 112 provides for taxation of long-term capital gains (LTCG). However, Section 10 (38) in-

troduced in 2004 provides for full exemption from Income Tax for long term capital gains (LTCG) provided a) The capital gain arises on transfer of shares of listed public companies; b) At the time of transfer, the transaction is chargeable to securities transaction tax (STT). In case of short term capital gains on listed securities (arising in less than 12 months), on fulfilling same conditions, Indian investor has to pay tax on STCG @ 10% u/s 111A. Twelve months holding period is applicable only for listed securities, in case of unlisted securities, the minimum holding period has to be 36 months, before it qualifies as long term.

However, majority of telecom holdings as discussed in this article are not listed securities. Hence they are subjected to taxation under the regular provisions of Income Tax Act. Thus in case of capital gain arising from sale of shares of unlisted entities, the taxation is as follows: a) In case of short term capital gain, the gain is included as income from other sources/ business Income as the case may be and charged to tax at full rate; and b) In case of LTCG, the gain is liable to tax @ 20% u/s 112.

Section 10(23G)

This section was introduced in 1995 with an objective of promoting investment in telecom sector by Indian and foreign investors. Telecom operators, whether listed or not were required to get the approval of Ministry of Finance u/s 10(23G) on submission of requisite details. In case a telecom entity was approved under this section, the investors in such entity were entitled, *inter alia*, tax exemption on long term capital, interest on long term finance and dividend. The approval was given by Ministry of Finance (MOF) on year-to-year basis or for a block of years based on satisfying eligibility criteria. It is pertinent to note that approval under this section is provided only to the operating company which owns telecom network and infrastructure and hence capital gain exemption was available in respect of capital gain arising on direct shareholding. In case of indirect holding, routed through chain holding, benefit of this section would not be available.

Most of the telecom operators had obtained approval u/s 10(23G). However this section has been withdrawn i.e. AY 2007-2008 after a 10-year period and henceforth this incentive is not available to the telecom sector.

Thus, proper tax planning for Indian and foreign investors to save their tax liability on future capital gains liability pose a great challenge. We will now discuss the Mauritius angle, through which most of the foreign shareholding are routed.

The Mauritius connection

The scenic Mauritius has emerged as the favourite landing point for foreign investors for FDI in Indian telecom companies. Mauritius accounts for more than a third of the aggregate FDI inflows. India's tax treaty with Mauritius provides exemption from capital gain arising out of Investment in India made by a Mauritius resident company. A common strategy adopted by foreign investors is to hold the shares of Indian operating company through Mauritius based special purpose vehicle (SPV). In case of exit, these SPVs are sold to foreign investors who land in Mauritius. Board level changes are made in such SPV and new investors take control of the SPV and nominate their representative on the Indian telecom company. In such a case, in accordance with DTAA with Mauritius, no capital gains tax is levied on the foreign investor. No transfer is needed to be recorded in the register of transfer of Indian telecom company as the same Mauritius SPV continues as shareholder.

Let us consider sale of direct holding in an Indian telecom company by a foreign investor. Say AB (Mauritius) Limited (an SPV and resident of Mauritius and referred as AB) holds 25% share capital of CD India Telecom Limited. AB is a 100% subsidiary of J Inc, USA. If J Inc wants to transfer its full stake to another foreign entity say EF (UK) Plc, UK then AB will sell all shares held in CD to EF. EF will lodge shares of AB, to the Indian company for registering them in his favour. The capital gain arising to AB on sale of EF is an offshore transaction and will not attract capital gain taxation in Mauritius or India due to DTAA with Mauritius. The directors nominated by AB are withdrawn and the new directors nominated by EF will take Board

position in CD's Board of Directors.

Now we will consider sale of indirect or beneficial holding. Say AB Mauritius Limited (an SPV and resident of Mauritius) holds 40% share capital of CD India Telecom Limited. The shareholders in AB Limited are A, Inc US (51%) and B Limited, Japan (49%). if A Inc and B Limited want to reduce their joint holding to 20% and sell balance 20% to a third investor say EF plc UK. Then A Inc and B Limited, will transfer their holding in AB to EF Plc and EF Plc will be inducted as another shareholder of Mauritius entity. Thus, by investing in AB Mauritius, EF obtains a beneficial holding in CD India equal to 20% and right to nominate 1/5th of number of Directors on the Board of CD India. Since, this transaction does not involve transfer of shares of an Indian company, no Capital Gain Taxation liability arises in India.

India's tax treaty with Mauritius has been an eye sore with Indian revenue authority for long. The controversy started after the Central Board of Direct Taxes (CBDT) issued a circular (No. 789 dated 13/4/2000) clarifying that a certificate of residence issued by Mauritius will constitute sufficient evidence for accepting the status of residence as well as ownership for applying the provisions of the tax treaty. The circular also clarified that the test of residence would also apply to income from capital gains on sale of shares. Thus, FIIs which are resident in Mauritius would not be taxable in India on income from capital gains arising in Mauritius country on sale of shares.

The above circular was declared invalid and quashed by the Delhi High Court *(Shiv Kant Jha versus Union of India, (2002) 256 ITR 563)*. But the Hon'ble Supreme Court reversed the decision of the Delhi HC and declared the circular valid *(Union of India versus Azadi Bachao Andolan, (2003) 263 ITR 706)*.

There are moves to bring the Mauritian tax treaty at par with Singapore treaty whereby, a resident of a contracting state (read Mauritius) shall be deemed to be a shell/conduit company and exemption from Capital Gains tax will be denied to such a company, if:

(a) Such a company is not listed on a recognised stock exchange of the contracting state; or

(b) its total annual expenditure on operations in that contracting state is NOT equal to or more than Rs. 5 million in the respective contracting state as the case may be, in the immediately preceding period of 24 months from the date the gains arise.

This amendment once approved is likely to put a spanner in the investment plan of foreign investors who have long utilised the loophole in DTAA with Mauritius without sharing any benefit of capital gain either with Government of India or Mauritius.

It is likely that foreign investors, who have used Mauritius as a safe route for Indian FDI, will take necessary steps to ensure compliance of the proposed guidelines by a) offloading the minimum stake required for listing on Mauritius based stock exchanges and listing of their SPV b) Maintaining office infrastructure and incur operational expenditure as per proposed guidelines.

Mauritius accounts for more than a third of the aggregate FDI inflows. India's tax treaty with Mauritius provides exemption from capital gain arising out of Investment in India made by a Mauritius resident company. A common strategy adopted by foreign investors is to hold the shares of Indian operating company through Mauritius based special purpose vehicle (SPV).

Licence fee on sale proceeds of licence:

As per current licensing guidelines, telecom operators have to pay licence fee on Adjusted Gross Revenue (AGR) which includes non operating revenue like revenue from handset sale, Interest revenue etc. There is no clarity whether the sale proceeds of a telecom licence

will be included within the levy of AGR and attract licence fee.

In this regard, let's review the case of Shyam Telecom Ltd (a DoT licencee itself), Holding company of Hexacom (Rajasthan Licence) who sold its Hexacom operation. The following extract from the Annual report of Public listed company Shyam Telecom (Year 2006, page 53) is self explanatory: "*The company sold its holding in HIL to Bharti Televenture Limited for a consideration of Rs 1751.87 Million. ……With respect to Income arising on transaction referred above, the company based on a legal opinion believes that it is not covered under the definition of Adjusted Gross Revenue, as inter alia, such revenue do not accrue out of operation licenced or require to be licenced by DoT… The issue is covered under generic petition filed by Association of Basic Telecom operators (ABTO) with TDSAT contesting the inclusion of non telecom related service revenue in the AGR which is pending resolution. In view of the legal opinion obtained by the company and the above petition filed by ABTO with the TDAST, the company is of the opinion that no revenue share is payable from sale of above investments and has accordingly made no provisions in its books of accounts.*"

EMERGING OPPORTUNITY FOR CAs

Mergers and Acquisitions in telecom sector have showered a boon for professionals including Chartered Accountants and finance community in general. As per an industry estimate, the telecom industry is likely to provide cumulative employment at various levels to over 4,000 Chartered Accountants to support its growth plans.

Some of the emerging area of practice for Chartered Accountant firms in telecom industry include following:

- Business Process outsourcing like Financial reconciliations, Bills Processing, Collection, Bill delivery, Payroll outsourcing, Customer refunds and Credits, address and identity verification, Revenue accounting, Back end compliant resolution on financial issues etc.
- Management Audit on telecom Industry process like billing process, Revenue Assurance process, Collection and Credit control process, Bill delivery and returned bills management.
- Assignments on Internal Controls and Six-sigma implementation.
- Certifications under Income tax law.

As the telecom operators consolidate their operation, they are likely to outsource more and more operational and financial activities. Chartered Accountant firms which have attained economies of scale and have knowledge base, operational skills, IT savvy team, cost effective manpower support are likely to see a vista of opportunity ahead of them in India's telecom Industry.

CONCLUSION

India needs a whopping US$30 billion to meet 22% teledensity target (250 million telephones) by the end of 2007 as set by DoT. Government's decision to raise the foreign investment limit to 74% is expected to spur fresh round of mergers and takeovers in India. The sector has slimmed from more than 20 carriers to 5-6 major players in 2006 and telecom pundits believe that a final round of consolidation to churn the number of players is in the offing. The possibility of realignment of shareholding structure in existing licences and entry of new investors also cannot be ruled out. The sector thus represents humongous opportunity waiting to be tapped by Indian and foreign conglomerates.

Critics claim telecom mergers reduce competition and promote monopoly. In reality, these mergers are part of a healthy competitive process and would foster innovation and bring benefits to consumers.

Finally, the success of a merger hinges on how well the post-merged entity positions itself to achieve cost and profit efficiencies. As Robert C Higgins of University of Washington points out "careful valuation and disciplined negotiation are vital to successful acquisition, but in business as in life, it is sometimes more important to be lucky than smart." ❐