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Analysis

Investing into Infrastructure Holding Companies: What if you become a core investment company?

Key Takeaways

- Infrastructure companies are mandated to execute concessions through SPVs, which often results in qualification of the holding company as a core investment company (CIC)
- CIC risk is often avoided by structuring EPC and O&M revenues through the holding company and swelling the operational income
- Regulatory approvals and RBI supervision could make investors apprehensive; in general, however, compliances and disclosure obligations remain light-touch
- Leverage caps on CICs make them tax sub-optimal, though careful structuring could optimise for tax leakages

What is a CIC?

In sectors such as infrastructure, holding companies may be necessary since concession agreements often require a separate entity to house the assets.

Holding companies typically have minimal operating activities and only invest in debt/ equity instruments issued by the group SPVs. Unless operational income is more than financial income (say if a concession is held at the holding company level or it has significant O&M/ EPC income), there is a risk of the holding company being classified as a core investment company (***CIC***).

To quickly recap, a company needs to fulfil two tests to qualify as a CIC.

a. *First*, the 50-50 NBFC test or the principal business criteria test (***PBC Test***), which states that 50% of the assets of an NBFC should be financial assets and 50% income should be from those financial assets; and

b. *Second*, the 90-60 CIC test which states that 90% of net assets[1] should be in the form of securities of group companies and 60% of net assets should be in the form of equity shares or compulsorily convertible instruments of group companies.

RBI's FAQs prescribe that CICs need not meet the 50-50 test – what's the view?

The prevalent view, arising from the RBI's Master Directions, is that a CIC is an NBFC which fulfils the 90-60 test. This means that if more than 50% of a CIC's income is operational income, they would not meet the PBC Test of an NBFC and therefore would not qualify as a CIC. However, the RBI spoiled the party when in 2016 they introduced FAQs which stated that CICs need not mandatorily meet the PBC Test.

However, if this view is accepted, holding companies with substantive operating income could also qualify as CICs, purely by virtue of its subsidiary relationships. We believe this could not have been the legislative intent. In fact, this issue has been debated extensively and despite the 2016 RBI FAQs, the prevalent market view is that a CIC must always be an NBFC first and fulfil the PBC test.

An operating company discovers that it is a CIC – what should it do?

Companies need to obtain a CIC registration upon meeting two thresholds - if turnover is above INR 100 crore as per the last audited balance sheet, <u>and</u> if they access public funds (which includes shareholder loans but excludes debt instruments mandatorily converting into equity in 10 years).[2] Such companies need to apply to the RBI for registration within

[1] "Net assets" mean total assets excluding - (i) cash and bank balances; (ii) investment in money market instruments and money market mutual funds (iii) advance payments of taxes; and (iv) deferred tax payment.
[2] Paragraph 6 of the CIC Master Directions.

three months of becoming a CIC. The threshold for ‘becoming’ a CIC is calculated at the time of preparation of the audited balance sheet, and not at any point in time.

From an exchange control perspective, a CIC also needs to obtain approval from the Ministry of Finance (***MoF***) for accepting any foreign investments per the Non-Debt Instrument Rules (***NDI Rules***).[3]

Now you qualify as a CIC – is it really that bad?

The general market perception is that a CIC-tag involves onerous reporting, regulatory and other compliances. We set-out some of the most critical considerations that one should keep in mind when they qualify as a CIC.

a. Prior approval for foreign investment: The CIC-classification could be a concern for foreign investors as investments into CICs and similar holding companies require prior approval by the MoF. In our experience, the approval process could take 8-12 weeks or longer. Interestingly, systemically important NBFCs (with an asset size of more than INR 500 crore) are exempt from prior government approval, but CICs with a rather contained risk profile are subjected to prior government approval for foreign investments.[4]

b. Leverage caps: Registered CICs are proscribed from borrowing more than 2.5 times their net worth.[5] The RBI has defined ‘net worth’ of a CIC in a specific manner known as ‘adjusted net worth’. This is essentially the equity capital, share premium and free reserves (with a few adjustments). Certain lenders may prefer to lend at the holding company level for benefits such as cross-collateralisation. However, the limitation on the debt-equity ratio handicaps the CIC from availing higher debt and making its capital structure tax optimal. Restrictions on debt (including shareholder debt) implies higher corporate taxes on the CIC as the tax shield on interest payouts is not available.

   Whilst this may be seen as a tax handicap, the tax leakages could be mitigated by borrowing directly at the project SPV level.

c. Risk adequacy ratios: Registered CICs should ensure that their adjusted net worth is not less than 30% of the investments they make.[6] In other words, CICs can invest only up to 3.3 times its adjusted net worth. For context, slightly riskier investments such as equity, private debt, etc. are allocated a risk weightage of 1:1, while secure investments

[3] Schedule I, paragraph v(A) of the Non-debt Instrument Rules 2019.
[4] It appears that the genesis of this approval requirement lies in RBI’s Press Note 4 of 2009. This introduced the concept of ‘investing companies’ for the first time, defined as “*an Indian company holding only investments in other Indian company/ ies directly or indirectly, other than for trading of such holdings or securities*.” It stated that foreign investment into such companies could only be through the approval route. Ideally, however, any regulated financial services entity (including a registered CIC) should be exempted from prior regulatory approval.
[5] Paragraph 9 of the CIC Master Directions.
[6] Paragraph 8 of the CIC Master Directions.

such as sovereign bonds, cash, etc. are allocated a risk weightage of 0. Again, this restriction affects the tax optimization of the CIC due to limited interest expense build-ups. Therefore, if a CIC has net worth of $100 and reaches the investment cap of $330 but group SPVs require further investment, shareholders will have to infuse additional funds through equity to increase net worth and maintain the 30% net worth restriction.

d. *Marketability Risk*: CICs need to take RBI approval for any change in control or for change in shareholding above 26%.[7] This restriction could affect investors' share marketability.

Conclusion

In addition to the above, CICs have certain reporting requirements as well such as liquidity details, consolidated financials for the group as a whole, details of dividends declared, etc. However, these may not be very cumbersome. Naturally, though, it is better not to be regulated than to be regulated. To that extent, the most common way of avoiding a CIC classification is by routing EPC and O&M fees through the holding company. This swells up the operational income, which prevents the company from meeting the PBC test, and hence the NBFC classification. Another option is structuring the entity as an LLP to avoid the NBFC classification.

Notwithstanding the above, the RBI, in our view, should consider exempting CIC/ investing company classification for holding companies in the infrastructure sector, especially where holding company structures are mandated by concession agreements. Even if such an exemption is not granted, foreign investment in registered CICs in the infrastructure sector should at least be brought under the automatic route to ease foreign investments in a sector that needs it the most.

[7] Paragraph 27 of the CIC Master Directions.

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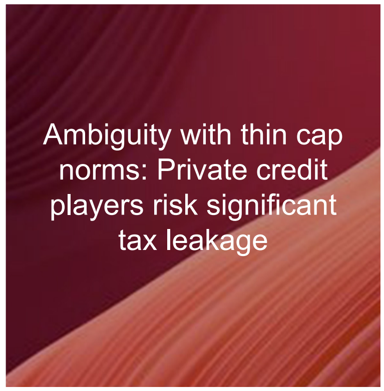

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