INDONESIAN M&A – STRUCTURED SOLUTIONS FOR FOREIGN INVESTMENT IN RESTRICTED SECTORS

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Legal Briefings – By **VIK TANG AND INDRANEIL GHOSH**

In this piece, we focus on some of the structuring solutions that have been used for foreign investment in restricted sectors of the Indonesian market in recent years. As you will see, these involve use of hybrid debt-equity structures overlaid by a complex interplay of foreign investment and public market laws.

NEGATIVE LIST

A key threshold issue relating to foreign investment in Indonesia is whether a foreign investor is able to buy equity in a private Indonesian target company.

In general, Indonesia has an open foreign investment regime, subject to restrictions in certain sectors. Some sectors are completely closed to foreign investment, while others are either completely open or open subject to limits or conditions as set out in the "Negative List".

The Negative List is a presidential decree (updated periodically) which sets out the extent to which foreign investors can invest by reference to a catalogue of business sectors.

In addition to compliance with the Negative List restrictions, before a foreign investor can acquire shares in a private Indonesian company, the target company must also be converted into a "PMA company" (Penanaman Modal Asing or foreign capital investment company) and be regulated by Indonesia's foreign investment regulator – the Capital Investment Coordinating Board (Badan Koordinasi Penanaman Modal or BKPM) – going forward.

Any investment by a PMA company (for example, in its subsidiaries) will also be treated as “foreign investment”, meaning that each such entity should also strictly speaking be required to convert into a PMA company. This could trigger divestment obligations at the core operating subsidiary level, although compliance with this requirement varies.

PMA companies are, in general, subject to greater regulatory scrutiny and restrictions on operations than local non-PMA companies (which lack foreign shareholders). Any foreign investment could therefore have an adverse impact on the target company’s existing operations if it operates in a sector closed for foreign investment.

In response to these regulatory challenges, deal structures in Indonesia (particularly in sectors that are closed or partially closed for foreign investment) have developed into complex and heavily structured investments, often involving the innovative use of: (a) the Indonesian capital markets and/or (b) debt instruments with equity-like features, such as convertible bonds and loans with warrants or put options attached.

INDONESIAN CAPITAL MARKETS – PORTFOLIO INVESTMENT EXCEPTION

In general terms, BKPM does not oversee investment in public companies which are listed on the Indonesian Stock Exchange (IDX). Prior BKPM approval of transactions involving listed companies, and PMA status, is therefore not generally needed for foreign shareholdings in listed companies, save in certain limited cases. Regulation of investment activity in the capital markets is seen as the preserve of Indonesia’s capital markets regulator, OJK (Otoritas Jasa Keuangan or Financial Services Authority).

Where the target listed company operates in a closed sector, foreign investors will need to rely on the exemption under the Indonesian investment law for "portfolio investments", as the basis for maintaining that the investment is not subject to the Negative List restrictions.

Since the term "portfolio investments" is not clearly defined, a plan to purchase a large stake in a company will require careful consideration if the target company operates in a closed sector.

To benefit from this exemption, the target company must first be listed on the IDX.

This is typically achieved through a domestic IPO of the target company, primarily to meet the minimum regulatory requirements for an IPO, instead of raising a meaningful amount of capital from the public market and/or creating a viable market for trading the target's shares on the stock exchange. A limited IPO of this nature helps preserve the “private” nature of the target company in all but name.

DEBT INSTRUMENTS WITH EQUITY-LIKE FEATURES

Negative list restrictions also do not apply to debt investments. As a result, convertible bonds and similar instruments that are documented as debt instruments, but with equity-like features (rights to appoint directors, approve business plan, benefit from capital upside on an exit, and so on), are sometimes seen as the route for investment into Indonesia (typically where the investment is geared towards an IPO exit). This is particularly so for target companies in fully or partially closed sectors.

Typically, these instruments are mandatorily convertible into shares of the target company upon an IPO. Accordingly, they have to be designed with an IPO in mind, whether a limited IPO to take the target company outside the regulatory purview of the BKPM (as described above) or a more meaningful capital raising as the ultimate exit route. The investment terms are therefore carefully constructed on a case-by-case basis, taking into consideration the wide range of regulations that apply to an Indonesian listed company.

GOVERNANCE

Since the mandatorily convertible bonds (MCBs) discussed above are meant to mirror an equity investment, the starting point for foreign investors is often to seek rights commensurate with a significant minority position – including the right to appoint a director and/or commissioner to the board and certain reserved matters (veto rights, including over appointment and dismissal of CXOs, approval of the business plan and budget, etc).

This default position then needs to be tested against multiple layers of regulatory requirements that need to be complied with.

The key issue at the heart of the main regulatory requirements is whether the proposed governance rights will give the foreign investor “control” over the Indonesian target company. The test for “control” is defined, and applied, somewhat differently by various Indonesian laws. Depending on whether these tests are satisfied, different regulatory consequences follow.

Portfolio investment exemption: The term “portfolio investments" is not clearly defined, but a key consideration in determining whether the investment in question falls under the portfolio investment exemption is the foreign investor’s ability to “control” the listed target company. If, through its governance rights, the foreign investor is deemed to be controlling the target company, then the portfolio exemption will not be available.

Public float requirement: In order to conduct an IPO, the target company must satisfy the minimum public float requirements of the IDX. This means that, among other things, a certain minimum percentage of the target company’s share capital must be held by shareholders that do not have “control” over the target company.

Merger control: If, through its governance rights, the foreign investor is deemed to be controlling the target company, a merger control notification may be required. For this purpose, “control” is defined by Indonesia’s merger control legislation as both direct control (ie holding at least 50 percent of voting rights) and indirect control (eg through shareholder veto rights).

Mandatory Tender Offer (MTO): The definition of “control” in the context of an MTO is similar to that relating to merger control. If, owing to its governance rights, the foreign investor acquires sole or joint control of the target company, it will be required to offer to purchase the shares held by certain minority shareholders in the target company.

Mitigation measures: Various measures may be used to mitigate the impact of these regulatory challenges, and the documentation of governance rights will need to be managed responsibly.

REDEMPTION

Depending on the bargaining power of the parties, MCBs may or may not have a fixed maturity date (and resultant downside protection by way of a redemption right).

The target company will typically resist a fixed maturity date on the basis that the bond acts as a proxy for equity, which does not have downside protection. The expectation is that exit will be achieved by a secondary sale of the bonds in the market.

In practice, such hybrid instruments do not have a ready secondary market. Even if some domestic counterparties, which are intimately familiar with the vagaries of the Indonesian system and such structures, are comfortable buying such securities, international investors may not be familiar with such structures. Hence, from a foreign investor perspective, it is often argued that downside protection is required.

CONVERSION

Basis of conversion

Conversion is not always straightforward. There are broadly two approaches to conversion in the context of an MCB.

The first approach is to determine the number of conversion shares by dividing the principal amount of the bonds to be converted by the conversion price. The conversion price (which is usually equal to the IPO price) reflects the agreed valuation.

However, this means that if there is an issue of new shares by the target in which the foreign investor (as the bondholder) does not participate, its interest in the target will get diluted. This may occur on IPO if there is a primary issue of new shares, which is likely.

From the foreign investor’s perspective, it is best to fix the percentage of share capital in the target company that the conversion shares will represent on conversion (ie on IPO), instead of fixing the conversion price. In practice, this means that the dilution of the primary tranche of the IPO will be borne by the other existing shareholders, which may be difficult to achieve commercially – especially if the primary tranche is substantial.

Conversion price

The other complication to navigate is the IPO issue price. Under current OJK policy, the conversion price of the bonds must be the same as the IPO price. Consequently, the IPO pricing must be arranged to achieve this, which may not be easy in a substantive (as opposed to a limited) IPO.

If, for any reason, OJK does not apply its unwritten policy, OJK's written rules still automatically lock up a convertible security holder (post-conversion) if the conversion price is less than the IPO price. The lock-up applies to all converted shares and lasts until eight months after the IPO registration statement is declared effective by OJK. The lock-up requirement prevents the foreign investor from selling down its interest either on or shortly after the IPO.

CONCLUSION

Doing deals in Indonesia requires careful navigation of regulatory and commercial issues, which are often interlinked and complex. Foreign investors, especially those not familiar with the vagaries of the Indonesian market, should look to appoint counsel with extensive on-the-ground experience to be successful.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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