Our Views

Outdated Risk, Renewed Opportunities: A Case for Acquisition Financing

India, having drawn over USD 1 trn in FDI and led Asia's IPO surge, stands ready to define a new growth story. But no nation accelerates on global highways with domestic wheels held back. Restrictions born of a bygone era meant for an unsteady past must now yield to a resilient, transparent, and well-regulated India.

After the security market debacle that spanned the 90s and early 2000s, regulators intervened and restricted banks from financing sensitive sectors like stock purchases, real estate, gems & jewelry, etc. effectively not permitting banks to finance equity beyond a certain limit. These strictures were placed considering market volatility and lack of institutional capacity with banks in risk measuring and management.

Acquisition financing refers to debt funding used specifically to acquire equity. It is essentially a loan taken to buy another company. Globally, this is a common tool in M&A transactions, often forming part of a "leveraged buyout" structure. The appeal lies in capital efficiency given that debt is cheaper than equity. As a result, a buyer can justify a higher purchase price when part of the deal is financed by debt. In other words, debt financing lets acquisitions be value-accretive where pure equity would be too costly. This is beneficial not only for acquirers but also for sellers and investors, as it facilitates more competitive bids and unlocks value.

Multiple factors today make a compelling case to lift the restrictions on acquisition financing by Indian banks:

- **Banks Already Underwrite Similar Risks:** Banks already take on similar 'feared-upon' risk exposure, just in indirect ways. They finance companies based on enterprise value and cash flows (e.g. project finance, loans against assets, etc.). From a lender's perspective, financing an acquisition is not fundamentally different from any other large corporate loan. It is a credit decision based on the cash flows of the target and acquirer. Banks regularly lend for projects, expansions, and working capital by underwriting business risk and future cash flows. An acquisition loan, similarly, can be serviced from the acquired company's cash flows. A cash-flow lending approach to a merger or buyout is aligned in spirit with the credit appraisal banks perform daily. The loan's performance will depend on the merged entity's earnings, just as a project loan depends on project revenues. Banks should be free to analyze the risk and lend if it fits their appetite. Denying them this ability is essentially denying a legitimate business opportunity within a sound risk framework
- **Convergence of Borrowing Costs:** Over the past 25 years, India's interest rates have steadily declined and converged toward global levels. The historical premium that made INR debt far more expensive than USD debt, has shrunk. For instance, the spread between Indian and US 10-year bond yields hit just ~164 basis points in May 2025, India's 10-year G-Sec at ~6.25% versus the US 10-year at ~4.59%. This is the lowest gap in two decades, compared to spreads of 400–500 bps in the early 2000s. In practical terms, the cost advantage of foreign-currency borrowing has diminished, especially once currency hedging is accounted for

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Indian vs US 10-Year Bond Yields (2000-2025)

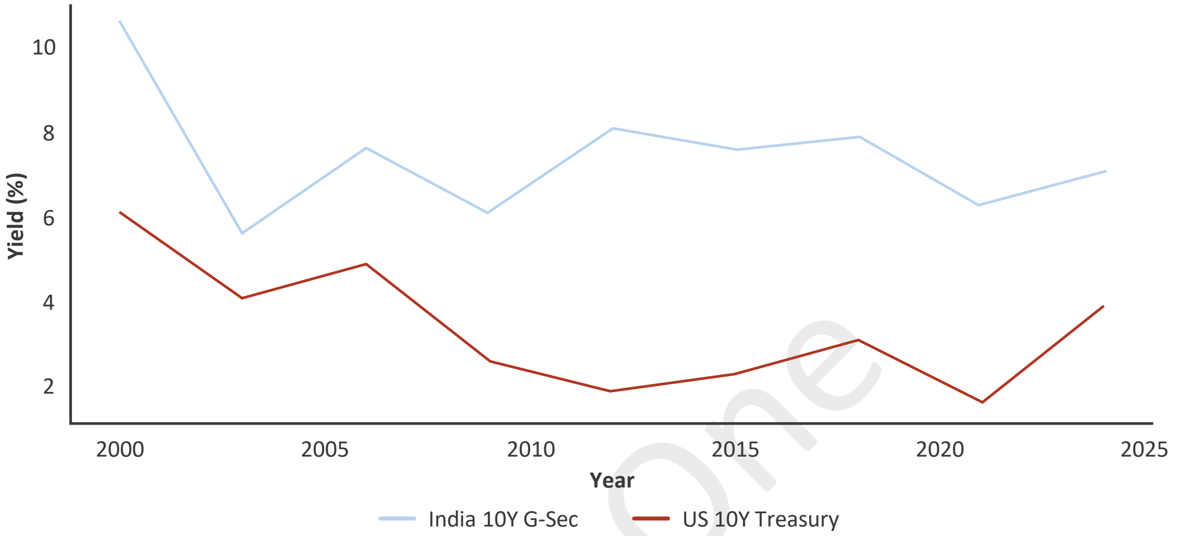

Figure: Convergence of 10-Year Government Bond Yields – India vs. USA (2000–2025). Indian G-Sec yields (yellow) have fallen from double-digits in early 2000s to ~6–7% in recent years, closing the gap with US 10- year Treasury yields (orange). The yield spread between the two is at multi-decade lows, about 1.5–2% in 2025.

(If an investor reinvested annually at the prevailing 10-year bond yields each year from 2000–2025, the compound annual return (IRR) would be roughly 7–8% in India vs. 3–4% in the US however the differential has markedly narrowed. In May 2025 India's 10 year bond yielded 6.25% while the US 10Y was 4.59%, a spread of only **164 basis points**. Hedging a USD loan into INR for such periods has often cost ~3–5% in forward premiums. Hence, post-hedge calculations imply that INR borrowing costs are in fact cheaper. The borrowing cost advantage for foreign currency debt has diminished, strengthening the case for rupee-denominated acquisition loans.)

- **Indian Banks Are Losing Market Opportunity:** The prohibition on acquisition finance means Indian banks have zero share in a large and growing segment of corporate credit, the financing of mergers and takeovers. In 2024, India saw M&A deals worth over $70 billion in disclosed value. Virtually none of this could be financed by Indian banks. Instead, acquirers resort to workarounds: domestic NBFCs, high-cost private credit, and offshore structures. Current strictures in place force acquirers to either borrow from NBFCs or issue NCDs (debentures) that are subscribed by foreign investors and funds. Frequently, Indian companies set up offshore SPVs to raise acquisition debt from international banks. This status quo is a lose-lose given that the Indian banks miss out on lucrative loan assets (high yield, secured by business cash flows), and Indian regulators lose some oversight as financing shifts to opaque offshore jurisdictions. The interest payments on these acquisition loans flow out to foreign lenders or shadow banks, depriving India's banking sector of income that it could earn if policies were liberalized.

Our Views

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- **Opacity and Regulatory Visibility:** Current financing structures for big acquisitions are often complex and less transparent. For example, an Indian conglomerate's takeover might be funded by a maze of offshore loans routed through subsidiaries in foreign jurisdictions, or by privately placed debentures to funds. Regulators have limited sight into these arrangements compared to bank loans under their direct purview. By contrast, if Indian banks were permitted to lend for acquisitions, the financing would occur under domestic regulation, with full visibility of source and use of funds. This enhances surveillance of systemic risks. Bringing acquisition finance onshore into the formal banking system reduces opacity and improves regulatory control.
- **Indian Corporates at a Competitive Disadvantage:** Perhaps the most compelling reason to lift the ban is to level the playing field for Indian companies and improving access to financing options. As of now, domestic corporates cannot easily leverage their own banks for acquisitions, whereas foreign competitors, including financial sponsors, can raise debt in their home markets to fund global M&A. The leverage ban handicaps Indian entrepreneurs by raising their cost of growth. Conversely, enabling rupee acquisition loans would bolster Indian companies' competitiveness, fueling a more dynamic domestic M&A environment.
- This prohibition was a safety measure in an era of weaker oversight and governance. Thirty years later, India's financial system has transformed. Corporate governance and risk controls have improved dramatically. Indian banks now follow stringent capital norms and robust credit-risk frameworks, and regulators enforce transparency in corporate dealings. The context which justified the ban has fundamentally evolved. India's regulatory ecosystem and bank risk management practices in 2025 bear no resemblance to those in 1992. With modern credit analytics and stronger corporate governance, banks are fully capable of assessing risks within their prudential norms. A well-regulated opening of acquisition finance by banks would reflect the maturity of India's markets in 2025.

Removing the blanket ban on acquisition financing, perhaps with prudent safeguards, will align banking policy with India's current economic reality. It's a timely reform that can drive growth, improve transparency, and strengthen the hand of Indian businesses in the global arena. Regulators today have an opportunity to catalyze the next wave of value creation by simply trusting the evolved risk management systems and allowing banks to do what they do best, 'assess credit and fuel growth'. The real beauty of India's M&A story is yet to unfold, and lifting this restriction will be a key step in that journey.

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