Reverse-Flipping: Indian startups return ‘home’ amid regulatory reforms

Indian startups are increasingly reversing their corporate structures, returning from overseas hubs due to regulatory changes, tax incentives, and favorable IPO valuations. The September 2024 amendment streamlines cross-border mergers, accelerating the reverse-flipping trend

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Indian Startups

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The practice of ‘flipping’ began in the early 2000s when Indian companies favoured foreign stock exchanges like NASDAQ, seeking higher valuations and a broader pool of investors. The typical structure involved shifting ownership to a foreign holding entity, making the Indian firm a wholly owned subsidiary, while its operations and market focus remained within India.

For many years, this was a common practice driven by access to deeper capital, more attractive valuations abroad, favourable tax and regulatory frameworks, better market penetration, and the benefit of branding as an international entity.

The Reverse-Flipping Trend

Historically, merging an overseas entity with an Indian firm required approval from the Reserve Bank of India (RBI) and the National Company Law Tribunal (NCLT), a process that could take anywhere from 6 to 18 months. The 2024 amendment, which introduces Rule 25A (5), removes the need for NCLT approval, allowing a faster, simplified cross-border merger process between a foreign holding company and its Indian subsidiary. The fast-track route under Section 233 of the Companies Act 2013 only requires RBI approval, significantly reducing the time and complexity involved.

The Foreign Exchange Management (Cross Border Regulations) 2018 also grant deemed approval for mergers, provided the companies comply with specified regulations, such as pricing guidelines, entry routes, and foreign investment conditions. Notably, any borrowings or guarantees of the foreign entity will become liabilities of the Indian company, subject to external commercial borrowing norms.

Role of Regulatory Reforms

These changes align with the strategies of several companies, which have already undertaken or are in the process of reverse-flipping. Firms like PhonePe, Groww, and Pepperfry have completed their moves, while others, such as Pine Labs and Razorpay, are still undergoing the process. Companies like Clevertap, Meesho, Kreditbee, Eruditus, Zepto, Flipkart, and Khatabook are reportedly considering similar moves.

This trend reflects India's growing economic strength, despite the high costs and lengthy timelines of reverse-flipping. For instance, PhonePe paid around $1 billion in capital gains tax to the Indian government to complete its move, while Groww incurred significant restructuring costs, paying approximately $160 million in taxes. Razorpay is expected to pay over $200 million once its move from the US to India is finalised.

The cost and duration of reverse-flipping vary depending on the method of restructuring. The two most common methods are share-swap, where shareholders swap their foreign entity shares for those in the Indian company, and inbound mergers, where the foreign parent merges into the Indian subsidiary. The share-swap method triggers capital gains tax in India for shareholders.

Policy Enhancements

The amendment to the Merger Rules is part of a broader trend of policy reforms aimed at encouraging businesses to return to India. The number of Indian firms with market caps exceeding $1 billion has reached record levels, and the Indian stock market has seen a surge in retail participation, with over 10 crore unique investors in 2024, compared to just 3 crore in 2020.

The shift is also linked to changing perceptions among global investors. **Ernst & Young reported in 2020** that most of their startup clients preferred a holding company based in Singapore or the US, with the subsidiary in India handling operations that primarily ran in India.

However, with the Indian regulatory environment becoming more investor-friendly, and Indian IPOs yielding higher valuations, many venture capital and private equity funds are now more comfortable with Indian start-ups. This is especially true in sectors like fintech, where regulators are seen to favour domestic firms when granting operational licences.

In 2024, Ernst and Young reported a preference from their clients for a **simply structured Indian entity**, which seemingly receives preferential approval from regulators as well. As per industry reports, the **RBI** as well as other regulators prefer local firms to their foreign counterparts for key operational licenses such as those necessary in the fintech industry.

The amendment is unlikely to be the last of changes driving Indian corporates home. The International Financial Services Centres Authority published a report titled '*Onshoring Indian innovation to GIFT IFSC'* which highlighted the policy changes needed to make relocation easier. Key among these changes are tax free, time bound redomicile process, more flexibility in instruments a start-up is permitted to use, easier exit norms for M&A and dedicated dispute resolution forums for the corporate law ecosystem.

Future Outlook

While regulatory changes are encouraging reverse-flipping, capital gains tax remains a significant hurdle. Indian start-ups relocating to India are still required to pay substantial taxes, which could deter some businesses. However, the momentum for reverse-flipping is only expected to increase. Industry estimates previously accounted for non-Indian domiciled unicorn startups and scaleups to amount to more than 50%.

The government's move to ease the process of return has helped India's appeal as a start-up destination. In the near future, 'flipping' may become obsolete as more companies opt to list within India, attracted by the country's investor-friendly ecosystem, growing stock market, and more competitive valuations.

Now industry figures at 3one4 Capital and Avendus close to 90% of India's foreign domiciled unicorns will flip with several companies already in the pipeline before the amendment. 'Flipping' is likely to cease entirely as more and more companies return home to the Indian ecosystem for its investor friendly frameworks and rapidly growing stock markets.

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