RBI'S REVISED PRICING NORMS

Background

Indian companies can issue equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares subject to pricing guidelines/valuation norms prescribed under Foreign Exchange Management (Transfer or Issue of Security to a Person Resident outside India) Regulations, 2000 ("FEMA Regulations"). Thus, one of the important factors with respect to any foreign direct investment in India is the pricing norm applicable to the instrument used whilst making the investment.

Erstwhile Pricing Regime

Historically until April 7, 2010, the exchange control regulations in India provided that the price of shares issued to a person resident outside India by an Indian company under the foreign direct investment scheme shall not be less than the price determined as per SEBI guidelines where the shares are issued by a listed entity and in other cases, not less than the fair valuation of shares done by a chartered accountant as per the guidelines issued by the erstwhile Controller of Capital Issues *(CCI Guidelines)*. The CCI Guidelines in turn provided that the value of equity shares of a company can be determined as an average of the value arrived at using the Net Assets Value method and the Price Earning Capacity method. It is noteworthy that the CCI Guidelines did not provide for valuation of preference shares or debentures.

Revised Pricing Guidelines

Recently, RBI has on April 7, 2010 amended the FEMA Regulations (which was published in the Official Gazette on April 21, 2010) to provide for new pricing guidelines. The revised pricing guidelines *inter alia* provides that the price of shares issued to persons resident outside India under the FDI Scheme shall not be less than (i) the price worked out in accordance with the SEBI guidelines, as applicable, where the shares of the company are listed on any recognized stock exchange in India; (ii) the fair valuation of shares done by a SEBI registered, Category - I Merchant Banker or a Chartered Accountant as per the discounted free cash flow method ("DFCF method"), where the shares of the company are not listed on any recognized stock exchange in India; and (iii) the price as applicable to transfer of shares from resident to non-resident as per the pricing guidelines laid down by the Reserve Bank from time to time, where the issue of shares is on preferential allotment.

Issues for consideration

In view of the revised pricing norms issued by the Reserve Bank of India, the following issues are pertinent and many of them require more clarity from the RBI:

<u>Preferential Allotment</u>: It is not clear whether the revised pricing guidelines for preferential allotment referred to above are applicable only in case of unlisted entities or it also applies to preferential allotment by listed entities as well.

<u>Discounted Free Cash Flow Method</u>: Whilst the CCI Guidelines provided operating guidelines for determining the fair value, the RBI has not prescribed any specific parameters for carrying out valuation under the DFCF method. Ordinarily, the DFCF method of valuation is based on assumptions of future numbers and generally takes into account future revenues, expenses and cash flows which is difficult to ascertain in case of a start-up or growth company. Contrary to pricing under the CCI Guidelines, where the issues of equity shares were made based on the past performance reflected in the last audited financial statement, foreign investors may be averse to paying value based on futuristic assumptions of cash flows.

<u>Convertible Instruments</u>: The revised pricing guidelines do not clarify the position for convertible instruments in view of the recent Consolidated FDI Policy issued by the Department of Industrial Policy and Promotions vide Circular No. 1 of 2010 dated 31 March 2010 (as updated by Circular No. 2 of 2010 dated September 30, 2010). The Consolidated FDI Policy clarified that pricing of capital instruments should be decided / determined upfront at the time of issue of such instruments.

Prior to April 1, 2010 issuance of convertible instruments such as compulsorily convertible preference shares or compulsorily convertible debentures were generally made at par/face value and the number of equity shares to be issued upon conversion were either decided upfront based on the value of equity shares on the date of issue of convertible instruments or were determined at the time of conversion. Parties were free to commercially agree upon the conversion ratio and the conversion price based on performance. However, in view of the revised pricing guidelines read with the Consolidated FDI Policy, now whilst issuing convertible instruments, the price per equity share needs to be determined as on the date of such issue using the DFCF Method of valuation and the conversion ratio needs to be crystallized on such date itself.

This may have an adverse implication for private equity investors who generally used to invest in convertible instruments where conversions were determined based on certain formula or future performance and earnings of the investee companies. This is because the fair value of start up or growth company shares can only be determined on future performance or at a time when preference shares / debentures are converted into equity. It is difficult to fix an upfront value on a share's premium.

No Grandfathering Provisions: Neither the revised pricing guidelines nor the Consolidated FDI Policy specify / clarify on whether the convertible instruments issued on or prior to March 31, 2010 can continue to be converted in the manner contractually agreed between the parties or if the parties would have to amend the terms of the convertible instrument to comply with the current regime of Consolidated FDI Policy. However, now the general belief is that even with respect to convertible instruments issued on or prior to March 31, 2010 the companies should have first determined the fair value of the equity shares as per the extant pricing guidelines under FEMA Regulations and thereafter, the price of the convertible instruments should have been worked out by determining the exact conversion ratio of the convertible instruments into shares.

Having said that, even if companies decide to fix the conversion ratio and the conversion price as of today, the question would be whether such ratio and the price have to be determined based on DFCF Method of valuation or whether they have to be determined based on the valuation norms prescribed under CCI Guidelines. Such determination of conversion ratio and conversion price would entail parties to enter into amendment agreements for restructuring the deals or amending the terms of the convertible instruments to comply with the Consolidated FDI Policy and FEMA Regulations. The unresolved issue: Whether the company would need to seek RBI's consent prior to amending the terms of the convertible instruments? This is because such revised terms will not be in consonance with the terms reported along with the FC-GPR filings and FEMA Regulations do not specifically permit the companies to revise the terms of the convertible instrument subsequently.

Conclusion

Whilst certain aspects of the revised pricing norms are quite clear, the RBI needs to still expressly clarify quite a few things including but not limited to specific parameters for determining the price using DFCF method of valuation, applicability of revised norms to convertible instruments and grandfathering provisions for convertible instruments. Recently, there have been deliberations amongst the regulators for relaxing the upfront determination requirement under the pricing norms for convertible instruments. However, such relaxation has a long way to go since it would require consensus among the RBI, Department of Economic Affairs and the Department of Industrial Policy and Promotions. Probably, we may get to see some clarity in the forthcoming Circular 1 of 2011 to be issued by the DIPP on March 31, 2011.