Revised Pricing Norms for Convertible Instruments

The Department of Industrial Policy and Promotion (DIPP) in the Ministry of Finance, Government of India has recently released the new Consolidated FDI Policy vide its Circular 1 of 2011 which came into effect from April 1, 2011. The revised Consolidated FDI Policy has introduced significant changes, one of them being the revisions made to the pricing norms applicable to convertible instruments being issued by an Indian company to a person resident in India.

Erstwhile Pricing Regime. It is quite common for foreign investors (particularly private equity investors) to invest in convertible instruments in Indian companies, which are start-ups or are on the growth track. These instruments are issued as either preference shares or debentures which are convertible into equity shares of the Indian company at a later date. The investor whilst investing in the convertible instruments intends to take commercial benefits of the future performance of the investee company such that the conversion price is linked to the future profits or earnings of the company.

During the year 2010, the DIPP had clarified in the erstwhile Consolidated FDI Policy issued vide Circular 1 of 2010 (as updated by Circular 2 of 2010) that whilst the issuances of capital instruments shall be subject to pricing guidelines/valuation norms prescribed under Foreign Exchange Management Act, 1999, the pricing of the capital instruments should be decided/determined upfront at the time of issue of the instruments. This revised pricing norm arrested the ability of the foreign investors to link the conversion price of the convertible instruments to future performance of the investee companies. Consequently, it adversely impacted various private equity players since a significant number of investments in the private equity space are made through convertible preference shares.

New Pricing Regime. According to certain news reports published in March 2011 it is understood that DIPP had written to the finance ministry in January 2011 proposing a change in pricing rules to help companies benefit from an upside in valuations of convertible instruments. It was reported that the RBI had agreed to some flexibility in pricing of FDI-compliant convertible instruments.

The revised policy on pricing norms for convertible instruments has thus been reflected in the new Consolidated FDI Policy issued by the DIPP vide Circular 1 of 2011. Paragraph 3.2.1 of the new Consolidated FDI Policy dealing with pricing of capital instruments reads as under:

> *"The price/ conversion formula of convertible capital instruments should be determined upfront at the time of issue of the instruments. The price at the time of conversion should not in any case be lower than the fair value worked out, at the time of issuance of such instruments, in accordance with the extant FEMA regulations [the DCF method of valuation for the unlisted companies and valuation in terms of SEBI (ICDR) Regulations, for the listed companies]. 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 FEMA Regulations."*

The revised pricing norm for capital instruments seems to be a step in the right direction. It is noteworthy that now the parties in an investment transaction can agree to a conversion formula for convertible instrument, whereas under the erstwhile Consolidated FDI Policy the conversion price has to be a fixed price decided upfront at the time of issuance.

Having said that, the conversion price at the time of conversion of capital instrument (which is determined in accordance with the conversion formula agreed at the time of issuance), cannot be lower that the fair value of the shares worked out at the time of issuance of the capital instrument in accordance with (i) discounted free cash flow method of valuation in case of unlisted companies; and (ii) SEBI (ICDR) Regulations in case of listed companies. Thus the DIPP has now set the fair value of the shares at the time of issuance as the floor conversion price such that any conversion of convertible instruments issued to a foreign investor cannot be made at a discount to such price.

The pricing norm is a welcome step for promoters and the companies who can now take advantage of better valuations in future due to better performance of the company. Thus, better the performance of the company lower the dilution of promoter's shareholding in the company upon conversion of convertible instruments issued to foreign investors. The revised pricing norm will also ensure that the parties are aware of the maximum dilution of promoter shareholding in the company in view of the fact that the conversion price will now be governed by the minimum floor conversion price. This may avoid disputes amongst the parties as has been in the recent past where the valuations of investee companies were drastically impacted due to recessionary trends.