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Raising Foreign Capital through FCCB and ADR/GDR

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☞ INTRODUCTION

In recent times, there has been a continuous surge in the issue of Foreign Currency Convertible Bond ("**FCCB**") and Global Depository Receipt ("**GDR**") with companies such as Reliance Communications, Mahindra & Mahindra, Ranbaxy resorting to the FCCB route to meet their financing needs. This newsletter seeks to analyze the meaning and salient features of these instruments. It further discusses the regulatory mechanism governing them and the reasons for their popularity. Finally, it touches the very vital issue as to whether FCCB is the answer to satiate corporate India's thirst for capital in all situations.

1. Meaning and Salient Features of FCCB and ADR/GDR

Issue of FCCB is governed by Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2004 (the "**Regulations**"). The Regulations define FCCB as a bond issued by an Indian company expressed in foreign currency, and the principal and interest in respect of which is payable in foreign currency.[1] A convertible bond is a quasi-debt instrument, which can be converted into equity shares at the choice of investor either immediately after issue, or upon maturity, or during a set period, at a pre-determined strike rate. It acts like a bond by making regular interest and principal payments, but these bonds also give the bondholder the option to convert the bond into stock. The investor benefits if the conversion price is higher than the traded price and suffers a loss if the traded price is higher than the conversion price. However, the investor has the discretion to hold the bond till maturity, receive regular interest payments and principal on maturity, without exercising the option of converting the debt instruments into equity.

GDR means a security issued by a bank or a depository outside India against underlying rupee shares of a company incorporated in India.[2] Security issued by a bank or depository in USA against underlying rupee shares of a company incorporated in India is known as American Depository Receipt ("**ADR**").[3] Therefore, the difference between ADR and GDR is only with respect to the location of depository or bank issuing the shares. FCCB is denominated in dollars or any other currency other than rupee. This brings about an element of exchange risk in the issue of FCCB due to currency fluctuations. In contrast, GDR is denominated in dollars with the equity shares comprised in each GDR denominated in rupees, hence, there is no exchange risk for the issuer.

2. Regulatory Framework Governing FCCB & GDR

In India, FCCB and ADR/GDR are issued in accordance with guidelines and regulations framed under Foreign Exchange Management Act, 1999 ("FEMA") the

[1] Clause 2(g) of the Regulations.

[2] Clause 2(i) of the Regulations.

[3] Clause 2(c) of Regulations.

Reserve Bank of India ("RBI")[4] and schemes notified by the Ministry of Finance, Government of India as well as the Regulations for FCCB. The latest comprehensive guidelines on the issue of FCCB have been consolidated in the "Master Circular on External Commercial Borrowings and Trade Credits" dated July 1, 2006 ("the Circular") issued by the RBI. The Circular is applicable for FCCB issuance as well.[5] Issue of ADR/GDR is governed by the RBI guidelines on foreign investments in India that have been consolidated into "Master Circular on Foreign Investments in India" dated July 1, 2006 (the "FI Circular").[6] Finally, issue of FCCB and GDR/ADR should also comply with the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 (the "Scheme") notified by the Ministry of Finance. Therefore, issue of FCCB/ADR/GDR is governed by four key regulations as aforesaid.

Further, issue of FCCBs will have to conform to the Foreign Direct Investment ("**FDI**") policy (including sectoral caps and sectors where FDI is permissible) of the Government of India and the RBI's regulations/directions issued from time to time.[7] Similarly, regulation 8.1 of the FI Circular states that Indian companies issuing ADR/GDR should not be ineligible in terms of the FI Circular to issue shares to persons resident outside India. This implies that issue of ADR/GDR will have to adhere to all such RBI guidelines on FDI as consolidated in the FI Circular. Accordingly, an Indian company engaged in retail trading cannot issue ADR/GDR/FCCB for raising capital as retail trading (except single brand product retailing) is a prohibited sector for FDI.

2.1 Regulatory Provisions under the Ministry of Finance Guidelines

In terms of the Scheme, prior permission of Ministry of Finance is not required for the issue of ADR/GDR if it is issued through an exchange that is registered with or recognized by the appropriate regulatory authority in the country of issue. Private placement of ADRs/GDRs is also eligible for automatic approval, provided the issue is lead managed by an investment banker.[8]

In order to bring the Scheme in alignment with Securities and Exchange Board of India ("**SEBI**") guidelines on domestic capital issues, the Ministry of Finance amended the same in August 2005[9] to include the following provisions:

1. An Indian company which is not eligible or is restrained[10] from raising funds from the Indian capital market will not be eligible to issue FCCB or ordinary shares through GDR.
2. Erstwhile Overseas Corporate Bodies ("**OCB**") not eligible to invest in India through the portfolio route and entities prohibited to buy, sell or deal in securities

[4] Section 6 (3) confers upon RBI the power to regulate, restrict or prohibit by way of regulations the capital account transactions mentioned under section 6 (3)(a) to 6(3)(j).

[5] The Master Circular no. 7/2006-2007 consolidates all existing notifications and circulars on the subject of "External Commercial Borrowings and Trade Credits". The introductory provisions of the Circular expressly state that policy for ECB is also applicable to FCCB. The Circular has a sunset clause of 1 year which means that it shall stand withdrawn on July 1, 2007 and will be replaced by an updated Master Circular on the subject.

[6] The Master Circular no. 2/2006-2007 on Foreign Investments in India. Even FI Circular has a sunset clause of 1 year which means that it shall stand withdrawn on July 1, 2007 and will be replaced by an updated Master Circular on the subject.

[7] Clause (i) of the Schedule to the Regulations.

[8] The Scheme was amended to include the automatic route of approval in January 2000 vide Press release F.No. 15/7/99-NRI dated January 19, 2000 issued by the Ministry of Finance. For the purpose of this Scheme, an investment banker is defined as an investment banker registered with Securities and Exchange Commission in the USA, or under Financial Services Act in UK or the appropriate regulatory authority in Europe, Singapore or in Japan.

[9] Vide Press release F. No. 15/4/2004-NRI dated August 31, 2005. Revisions/modifications to the operative guidelines of the Scheme are made from time to time by the Ministry of Finance.

[10] Companies restrained by SEBI order under section 11(4) (b) of SEBI Act, 1992 to access the securities market.

by SEBI will not be eligible to issue FCCB or ordinary shares through GDR.[11]

3. Unlisted companies issuing GDR/FCCB shall be required to simultaneously list in the domestic market.[12]
4. The ADR/GDR/FCCB issues should be made at a price higher of the following:

   (i) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six month preceding the relevant date;
   (ii) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the two weeks preceding the relevant date.[13]

The aforesaid pricing guidelines initiated a debate and were perceived to be unreasonable and indifferent to market realities. Such a pricing guideline restricts access to overseas capital.[14] The Ministry of Finance has offered some respite for the investors planning a simultaneous domestic and overseas issue.[15] Companies going public simultaneously in the domestic and foreign markets, or within 30 days of the domestic issue, are not obliged to conform to abovementioned pricing guidelines with respect to issue of FCCB and GDR/ADR, provided they secure approval from the market regulator. Also, the issue prices, both domestic and foreign, must be at par. Thus, SEBI is empowered to exempt companies from adhering to the pricing guidelines stipulated under the Scheme.[16]

2.2 RBI Guidelines

Though both the Scheme as well as the Circular stipulate eligibility criteria for borrowers and lenders, the Circular concentrates on volume of permissible total borrowing and its maturity structure as well as the permitted end use of the funds raised. On the other hand, the Scheme deals with the operational parameters of the issue including but not limited to pricing guidelines, listing requirements and issue structure.

2.2.1 FCCB

In terms of the Circular, FCCB can be accessed through two modes -automatic route and approval route. Under the automatic route, no approval is required from RBI. Indian companies (except financial intermediaries)[17] are eligible to raise an aggregate principal amount of upto US$ 500 million under the automatic route. Minimum average maturity for FCCBs upto US$ 20 million should be three years and for FCCBs between US$ 20 million and US$ 500 million, five years.[18]

The proceeds from the issue of FCCBs are permitted to be utilized only for the following end uses:

- For investment (e.g. import of capital goods), implementation of new projects, and modernization/expansion of existing production units in real sector, industrial sector including small and medium enterprises and infrastructure sector.

[11] OCBs have been prohibited from investing in any security in India vide Foreign Exchange Management (Withdrawal of General Permission to Overseas Corporate Bodies) Regulations, 2003.

[12] Unlisted companies, which had already issued ADRs/GDRs/FCCBs in the international market, were required to list in the domestic market on making profit beginning financial year 2005-06 or within three years of such issue of ADRs/GDRs/FCCBs, whichever is earlier.

[13] The "relevant date" means the date thirty days prior to the date on which the meeting of the general body of shareholders is held, in terms of section 81 (IA) of the Companies Act, 1956, to consider the proposed issue.

[14] The reasons for this are explained in section 5 of this newsletter.

[15] Vide Press Release dated November 17, 2005 issued by the Ministry of Finance.

[16] Section 11 of SEBI Act, 1992 empowers SEBI to perform functions mentioned therein. Section 11(2)(m) is the residuary clause that empowers SEBI to perform any other function that may be prescribed.

[17] Financial institutions dealing exclusively with infrastructure finance or export finance, textile or steel sector restructuring package can issue FCCB under the approval route.

[18] There is no limit on number of bonds that can be issued or size or value of each bond.

- For overseas direct investment in Joint Ventures ("JV")/Wholly-Owned Subsidiaries ("WOS") subject to the existing guidelines on Indian direct investment in JV/WOS abroad.
- For the first stage acquisition of shares in the disinvestment process and also in the mandatory second stage offer to the public under the Government's disinvestment programme of PSU shares.
- For lending to self-help groups or for micro-credit or for bonafide microfinance activity including capacity building by NGOs engaged in micro finance activities.
- Refinancing of an existing ECB/FCCB, provided that the fresh FCCB is raised at a lower all-in-cost[19] and the outstanding maturity of the original FCCB is maintained. This means that proceeds of FCCB may be used to refinance an existing FCCB issue provided that total amount payable on account of rate of interest, other fees and expenses is lower in the fresh FCCB issued than in the existing FCCB.

Indian companies are prohibited to use FCCB proceeds under the automatic as well as approval route for the following purposes:

- On-lending or investment in capital market or acquiring a company (or a part thereof) in India;
- Real estate;
- Working capital, general corporate purpose and repayment of existing rupee loans.

In terms of the Circular no guarantee, letter of comfort or letter of undertaking can be issued by banks, financial institutions or Non-Banking Financial Companies relating to FCCB. Further, the issue of security to be provided to the lender is left at the discretion of issuer company.[20] Prepayment of FCCB is permitted upto US$ 200 million subject to compliance of minimum average maturity period. For higher prepayment amount, RBI approval is needed.[21] The Circular provides that funds received through FCCB should be parked abroad till the actual requirement arises in India.[22]

2.2.2 GDR/ADR

The FI Circular contains provisions relating to issue of shares by Indian companies under GDR/ADR.[23] The proceeds must be kept abroad till actually required in India. There are no end use restrictions except for a ban on deployment/investment of such funds in real estate or the stock market.[24] A limited two-way fungibility scheme has been put in place by the Government of India for ADRs/GDRs.[25] This means that the depository receipts can be converted into underlying shares and vice versa. Under this scheme, a SEBI registered stock broker in India can purchase the shares from the market for conversion into ADRs/GDRs. Re-issuance of ADRs/GDRs would be permitted to the extent of ADRs/GDRs which have been redeemed into underlying shares and sold in the Indian market. Earlier, no re-issuance of depository receipts was permitted. Investors could only cancel the depository receipts and avail of the underlying shares or take back the proceeds by selling the underlying shares. Hence, over a period of time, the outstanding balance of depository receipts would get reduced thereby reducing the liquid float of depository receipts to the international investors. Two-way fungibility scheme overcomes this problem.

An Indian company can also sponsor an issue of ADR/GDR. Under this mechanism, the company offers its resident shareholders a choice to submit their shares

[19] All-in-cost includes rate of interest, other fees and expenses except commitment fees, pre-payment fee, and fees payable in Indian rupees, (para (iv) of part I(A) of the Circular).

[20] Creation of charge over immovable assets and financial securities, such as shares, in favour of the overseas lender is subject to Regulation 8 of Notification No. FEMA 21/RB-2000 dated May 3, 2000 and Regulation 3 of Notification No. FEMA 20/RB-2000 dated May 3, 2000.

[21] Para (ix) of part I (B) of the Circular.

[22] Para (ix) of part I (A) and para (viii) of part I (B) of the Circular.

[23] Regulation 8 of FI Circular.

[24] Regulation 8.1 of FI Circular.

[25] Vide A.P. (Dir Series) Circular No. 21 dated February 13, 2002.

back to the company so that on the basis of such shares, ADRs/GDRs can be issued abroad. The proceeds of the ADR/GDR issue is remitted back to India and distributed among the resident investors who had offered their rupee denominated shares for conversion. These proceeds can be kept in resident foreign currency (domestic) accounts in India by the shareholders who have tendered such shares for conversion into ADR/GDR.[26]

3. Reasons for increase in raising Overseas Capital through FCCB/GDR

The rush for FCCB issues is driven clearly in the light of cheaper funds abroad. The interest payable in case of FCCB is generally lower than on other loans or bonds. The Yield-to-Maturity (YTM)[27] in case of FCCB generally ranges from three to seven percent, much cheaper than the prevailing interest rates in the domestic market.[28] Further, there is a renewed confidence in Indian companies and they realize the need to have an offshore presence. Most of the GDRs/FCCBs are raised from stock exchanges like London, Singapore and Luxembourg exchanges where the disclosure norms are not very stringent. Further, FCCB's are attractive to both investors and issuers. The investors receive assured payments on the bond and also have the opportunity to take advantage of any price appreciation in the company's stock by means of warrants attached to the bonds that represent a right to acquire shares in the entity issuing the bond. Due to the equity side of the bond, the interest payments on the bond are lower, thereby reducing the costs for the issuer.

4. FCCB/GDR versus QIP

SEBI introduced the option for listed companies to raise funds through Qualified Institutional Placement ("**QIP**") as it was concerned over the growing number of Indian listed companies tapping funds through the GDR/FCCB route. In comparison with FCCB/GDR, QIP is a cheaper option to raise funds as the issue costs are lower. Further, it is a less time consuming option due to lower regulatory approvals which need to be procured. For example, there is no requirement of prior approval of the preliminary placement document before the issue of specified securities. Also, no pre-issue filing with SEBI is to be done. Therefore, QIP may prove to be a more viable option for medium sized companies to raise capital as they do not have global presence. However, there is a cap on the funds that can be raised through QIP in a financial year.[29] There is no such restriction on the amount that can be raised through FCCB/GDR. Hence, FCCB/GDR remains a viable option for raising funds on a large scale.

5. FCCB in a bearish run

In terms of the Scheme, issue of FCCB and GDR/ADR have to be priced at the average six monthly prices of the related shares or the average price thereof in the last fortnight before the 'relevant date'[30], whichever is higher. Such a provision makes it easy to raise capital in a situation when stock prices are generally on the rise. However, in a bearish market run, the stock prices fall and it becomes difficult to garner capital. Such a provision adds to the hardship of the investor by requiring the issues to be priced at the average six monthly prices or the average prices of the last fortnight before the due date.[31] In such a scenario, there remains very little scope for the companies to fetch capital

[26] Regulation 8.5 of FI Circular.
[27] Yield-to-Maturity is a premium to be paid at redemption if the bonds are not converted into equity.
[28] 3i Infotech's FCCB had a YTM of 5.8 per cent, Reliance Communication's $500-million FCCB issue had a YTM of 4.65 per cent, M&M five-year FCCB issue of $200 million had a YTM of 5 per cent, while Ranbaxy's $400-million February 2006 FCCB issue had a YTM of 4.8 per cent.
[29] The issue size in one financial year shall not exceed five times of the net worth of the issuing company at the end of its previous financial year.
[30] Supra, n. 12.
[31] Supra, n. 5.

and make profits. Thus, it is pertinent to note that FCCB/GDR cannot be considered as a viable option to raise capital in all situations as the instruments are sensitive towards the market trend.

☞ CONCLUSION

FCCB and GDR are being increasingly used by Indian companies as a major finance raising tool for meeting its capital requirements at competitive rates. The present regulatory environment has fully supported the industry's efforts to meet its financing needs by allowing issuers to raise considerable amounts under the automatic route. At the same time, steps have been taken to secure the interest of lenders as well as borrowers by excluding any tainted players. However, raising funds through FCCB/GDR is not feasible in a bearish market run. Further, the issue costs as well as the time taken to issue FCCBs or GDR/ADR, as the case may be, is considerable. This makes instruments like QIP a better option to raise funds for medium sized companies. Nonetheless, FCCBs/GDRs make available large scale cheap funds to satisfy the capital requirements of companies and it is likely that big sized companies would continue to resort to these instruments for their financial needs.

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