Business Standard

Convertible deals face valuation blues

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With the Reserve Bank of India (RBI) mandating discounted cash flow (DCF) method for valuation in case of transfer of shares to unlisted companies, entities that have done convertible deals are a confused lot.

Reason: It is not clear if the new norm applies to deals prior to the notification and where the conversion price has not been decided.

RBI effected these changes by amending the Fema (Foreign Exchange Management Act) guidelines.

Industry bodies and lawyers have approached RBI for clarity.

While the conversion price for deals already done is a grey area, experts say use of the DCF method for valuation at the time of conversion will hit private equity and strategic investors by resulting in a lower equity stake for them. This is because the DCF valuation will be higher than the book value, say experts.

Under the DCF method, a company's value is calculated based on projections of how much money it's going to make in the future. It is described as "discounted" because future cash is worth less than its value today.

"In cases where the conversion ratio is not fixed, the DCF valuation could come into play, possibly resulting in lesser number of shares being issued than under the previous guidelines. The DCF valuation will anyway be higher than the book value," said Gautam Mehra, executive director, tax and regulatory services, PricewaterhouseCoopers.

Convertibles have become a popular instrument for PE and strategic investors because of the downside protection they provide. They allow bonds to be converted into common stock when certain conditions are met. Generally, the conversion is linked to earnings before interest, taxes, depreciation and amortisation or operating profit of the company. So, if a company is not doing well, the investor's stake goes up and vice versa.

Upfront downside

"Valuation mismatch issues may arise if there is a requirement to determine the price upfront. As long as the issuer company's equity base value is met upfront, the subsequent conversion should be allowed to be a function of performance and actual balance sheet of the issuer company," said Richie Sancheti of Nishith Desai Associates

Earlier, fixing the conversion price upfront was not mandatory for companies and investors. Hence, they were free to decide the price either at the time of issuance or at the time of conversion. However, the new consolidated foreign direct investment policy says the conversion price has to be fixed upfront, that is, at the time of issuance. When read in conjunction with RBI's revised Fema guidelines, future convertible deals will have to be valued based on DCF analysis.

Recent examples of deals done through convertible instruments include Singapore-based Temasek Holdings' investment in GMR Energy and Motilal Oswal Private Equity's investment in Minda Industries.