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FCCB buybacks: Is the move enough?

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With dismal share valuations causing bondholders to redeem, and not convert their foreign currency convertible bonds (FCCBs), which until early this year were regarded as one of the most preferred options for raising corporate debt, suddenly seem to have become millstones around the necks of issuers.

It is the redemption pressure on cash-starved issuers, coupled with the need to preserve liquidity by mitigating further forex outflow which seems to have prompted the Reserve Bank of India (RBI) to issue the circular dated December 8, 2008 permitting buyback of FCCBs.

As per the circular, issuers can now buyback FCCBs under the automatic route up to any limit out of existing foreign resources or by raising fresh external commercial borrowings (ECBs,) if effected at a minimum discount of 15% on the book value. Further, FCCBs up to $50 million can be bought back with prior RBI approval out of rupee resources representing “internal accruals”, if effected at a minimum discount of 25% on the book value.

In fact, RBI allowed FCCB buyback earlier for a limited period from March 2003 to September 2003, under the automatic route up to a limit of $100 million, if the buyback was made out of local resources and without any limit, or if the buyback was out of Exchange Earner’s Foreign Currency (EEFC) funds or inward remittances toward equity subject to inter alia one condition — buyback should be effected at face value, and not book value. Book value is the face value of FCCB plus the interest accrued on the bond till the date of buyback.

While permitting buybacks at discount against face value will surely encourage bond holder interest, the extant buyback regime may disappoint the issuers on at least the following four counts: (a) not many issuers will have existing foreign resources to fund the buyback and raising fresh ECBs in such conditions will be very difficult; (b) the cap of $50 million will clearly be inadequate for funding buybacks; (c) buyback up to $50 million requires prior RBI approval, which could be time consuming, and most importantly; (d) even buyback up to $50 million cannot be funded out of the crucial funding channel of share proceeds. While the rationale behind other restrictions can probably be understood, RBI’s intent behind excluding share proceeds in times when FDI is most imperative is intriguing, and probably, stems from its disinclination to permit capital stock being used for discharge of loan stock.

However, this view lacks substance in light of the fact that the capital stock is not being reduced (but being replenished) to discharge the debt, and more importantly RBI does permit conversion of ECBs into shares, which is akin to buyback of FCCBs from share proceeds.

The exclusion, coupled with the restrictions mentioned above, actually frustrates the purpose of FCCB buybacks since most issuers may not have adequate internal accruals to fund the buyback or may like to preserve liquidity for tougher times ahead, and efforts to raise fresh funds will be futile.

While the move is indeed commendable, if RBI does want more buybacks to be effected, it should ideally permit buybacks out of share proceeds at a stipulated discount or even face value leaving the commercials to the parties. Subjecting buybacks to such fetters will defeat the purpose of buyback, handicap the issuers from making an offer for buyback thereby causing greater financial pressure on the issuer and the economy when the bonds come up for redemption.