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Raising debt the FCEB way

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Until recently, the only options available for an Indian corporate to raise overseas debt were either by way of external commercial borrowings ('ECBs') or by way of foreign currency convertible bonds ('FCCBs'). There was, however, no mechanism whereby the promoters of Indian companies could unlock value in their group companies to raise funds abroad.

On February 15, '08, Finance Ministry finally notified the scheme for the issue of Foreign Currency Exchangeable Bonds Scheme, 2008 ('Scheme') allowing Indian companies to leverage value in their listed group companies by way of issue of Foreign Currency Exchangeable Bonds ('FCEBs').

In terms of the scheme, any Indian company ('Issuing Company') may, with prior approval of the Reserve Bank of India and subject to ECB Guidelines, issue FCEBs convertible into shares held by it ('Offered Shares') of another listed company ('Offered Company') having the same promoter group (as defined in the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000) as the issuing company and invest the proceeds thereof into any of the promoter group companies. The essential difference between an FCCB and FCEB lies in their convertibility. Unlike an FCCB, which is convertible into new shares of the issuing company, an FCEB is convertible into existing shares of the offered company held by the issuing company. While both exchangeables (FCEB) and convertibles (FCCBs) are fairly common internationally because of the cheaper opportunistic funding, diversification, volatility play and strategic financing they offer, exchangeables outshine convertibles on atleast the following three counts — Effective exit mechanism, Dilution and Diversification.

From a bondholder's perspective, FCEBs entitle the bondholders to listed offered shares which can be easily disposed off on a stock exchange as against unlisted shares which may not be as marketable. FCEBs have been seen to outperform the offered shares in adverse market situations due to the assured returns (coupon payment) and perform just as good or even better than the underlying offered shares in an appreciating market.

Documentation for exchangeables differs from that of a convertible on at least the following three counts:

(a) Representations and warranties: As the offered company may not be under the control of the issuing company, the warranties to be given by the issuing company in respect of the offered company and the offered shares should be carefully evaluated, preferably restricting them to qualified responsible statements.

(b) Anti dilution: The offer document should preferably stipulate the value that the bondholder will receive if the offered shares are diluted due to any change in the capital structure of the offered company, and not the issuing company.

(c) Take over: What happens when the offered company is taken over by another company? Though, typically, exchangeable bonds in a takeover allow for the bonds to be exchanged for the takeover consideration, these eventualities should preferably be thought out beforehand and stipulated in the offer document.

From a tax perspective, conversion of FCEBs into shares and transfers of FCEBs outside India between two non residents does not give rise to any capital gains tax in India.

While the coupon payment made to the bondholders is a tax deductible expense for the issuing company, the interest income in the hands of the recipient (bondholder) will be subject to a withholding tax at the rate of 10% (exclusive of surcharge and education cess) in India. Further, sale of offered shares would attract long term or short term capital gains tax depending on the period they have been held for, which will be calculated from the date of their conversion. The recent Tata Steel-Corus deal probably best summarises the essence, need and advantages of FCEBs for corporate India. The availability of the scheme could have enabled Tata Sons (the promoter company) to issue FCEBs convertible into highly valued and appreciating shares of TCS to raise funds for Tata Steel to finance the acquisition of Corus. This way, Tata Sons could have deferred the sale of TCS shares to protect its earnings until Corus turned profitable and generated returns required for redemption of TCS shares, rather than divest its stake in TCS immediately at an inappropriate time.

Whilst the scheme has been welcomed by corporate India, it remains to be seen as to what extent are FCEBs regarded as the preferred option for fund raising and how creatively can the Indian companies use the scheme to unlock value in group companies in light of ECB Guidelines and other securities laws considerations. **The author is with Nishith Desai Associates. Views are personal**