Funds Hotline

January 17, 2014

FOREIGN INVESTORS PERMITTED TO PUT: SOME CHEER, SOME CONFUSION

- Amendment recognizes shares/debentures with a built-in option/right as eligible instruments which may be issued to foreign investors;
- Such securities cannot have an assured exit price, although the Amendment specifies methodologies to determine the exit price;
- The prescribed price determination measures may make it more beneficial to invest in compulsorily convertible securities rather than equity shares;
- A minimum lock-in period of one year has been prescribed before the option can be exercised.

'Put Options' in favour of a non-resident requiring an Indian resident to purchase the shares held by the non-resident under the foreign direct investment ("FDI") regime were hitherto considered as violative of the FDI Policy by the Reserve Bank of India ("**RBI**"). The RBI has now legitimized option arrangements through its recent amendment ("**Amendment**") to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) Regulations, 2000 ("**TISPRO**"), notified through its circular[1] dated January 09, 2013 (the "**Circular**"). TISPRO now recognizes that equity shares, fully and mandatorily convertible preference shares and debentures ("**FDI Instruments**") containing an optionality clause can be issued as eligible instruments to foreign investors. However, the Circular specifies that such an option / right when exercised should not entitle the non-resident investor to exit at an assured return.

BACKGROUND

The validity and enforceability of put options has always been a bone of contention from an Indian securities law and exchange control perspective.

In the past, Securities and Exchange Board of India ("**SEBI**") had taken a stand, in context of public companies, that option arrangements are akin to forward contracts, hence restricted. SEBI relaxed its position through a notification[2] in October, 2013. The SEBI notification granted validity to contracts containing clauses related to preemptive rights, right of first offer, tag-along right, drag-along right, and call and put options.

From an RBI perspective, the issue was more from an external commercial borrowings ("**ECB**") perspective. RBI had issued a notification on June 8, 2007 vide Circular 73, setting out that non-residents could only subscribe to FDI Instruments, and any instrument that may be redeemable or optionally redeemable will qualify as ECB. Interpreting that Circular, the RBI regarded put options in favour of non-residents as redeemable instruments, not permitted under the FDI regime. That interpretation was even extended to situations where the put option was not on the company, but the promoters of the company.

On a separate count, taking a cue from SEBI, the RBI also took a view that a put option provision in an investment agreement would qualify as a 'option' or an over the counter derivative, which is not permitted under the FDI route. That view was taken despite the fact that no separate price was paid for the optionality, and the optionality could not be traded independent of the FDI Instrument.

Having said that, there was no clear written policy that restricted put options, and RBI's approach was seen to be on a case-to-case basis, typically in cases where the promoters (not willing to honor the put) approached the RBI themselves. However, the aggressiveness with which the RBI implements such an unwritten policy was remarkable. The risk of having a put was not just limited to it being not enforceable, RBI in fact regarded the mere existence of put in a contract as a violation of the FDI Policy and initiated proceedings against the parties for having provided for such options in their investment contracts.

In fact, the Department of Industrial Policy and Promotion (DIPP) had brought in a written prohibition on options in the Consolidated FDI Policy dated October 01, 2011, but deleted that provision within 30 days of it in light of industry wide criticism. However, notwithstanding the deletion of prohibition of options, RBI continued with its approach that put options in favour of non-residents were violative of the FDI policy. Please refer to our hotline discussing the change in regulatory policy here and here.

AMENDMENT

The Amendment, for the first time, provides for a written policy on put options, and in doing that sets out the following conditions for exercise of options by a non-resident:

1. Shares/debentures with an optionality clause can be issued to foreign investors, provided that they do not contain an option/right to exit at an assured price;
2. Such instruments shall be subject to a minimum lock-in period of one year;

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3. The exit price should be as follows:

- In case of listed company, at the market price determined on the floor of the recognized stock exchanges;
- In case of unlisted equity shares, at a price not exceeding that arrived on the basis of Return on Equity ("**RoE**") as per latest audited balance sheet. RoE is defined as the Profit after Tax divided by the net worth (defined to include all free reserves and paid up capital)
- In case of preference shares or debentures, at a price determined by a Chartered Accountant or a SEBI registered Merchant Banker per any internationally accepted methodology.

ANALYSIS

In a market where IPOs are almost non-existent, put options give tremendous comfort to offshore private equity funds, should a trade sale not materialize within their exit horizons. Put options become even more important for certain asset classes like real estate or other stabilized yield generating assets where secondary sales and IPOs are not very common in the Indian context. The Amendment is a positive development for such players as commercial justifications behind inclusion of options into investment agreements have been recognized, and Indian companies and their founders can no longer treat such rights/options as mere paper rights.

A detailed analysis of the Amendment, its ambiguities and practical challenges are set out herein below.

1. Lock in

- While a minimum lock in period of one year has been specified, it is unclear as to which date it should apply from. For example, if the date of optionality agreement and issuance of securities are different, which would be the relevant date? On a conservative basis, it may be appropriate to reckon the lock-in conditions from the later of the two dates.
- There are also issues about whether the lock-in restricts only the exercise of securities or also the secondary transfer of securities, as well as whether a secondary transfer would reset the clock in the hands of the new investor. It appears that the one year lock would be required only if the option is being exercised (and not in case of all secondary transfers), and would apply afresh in the hands of each subsequent transferee.

2. *Will DCF pricing cap still apply, if the exit price for options is higher than DCF*

- Under the current regulations, non-residents are not entitled to sell the FDI Instruments to an Indian resident at a price exceeding the price computed per the discounted free cash flows ("**DCF**") methodology.
- However, the DCF cap applicable to FDI Instruments will not be applicable to sale of FDI Instruments with a put option. This is because the exit pricing applicable in case of exercise of the option by the non-resident has been introduced by amendment to Regulation 9 of the TISPRO regulations, whereas the DCF price cap is applicable to securities transferred under Regulation 10 B(2) (by virtue of the RBI circular dated May 4, 2010). Regulation 10B only applies to transfers by non-residents, which are not covered under Regulation 9. Therefore, the DCF cap will not be applicable when determining the exit price pursuant to exercise of put option.
- The question remains on whether the option pricing norms set out in the Amendment will only apply if the option is exercised, or even if shares with options are transferred to the grantor of the option without the exercise of an option.

3. *Exit price for equity shares*

- The Amendment provides that the exit price in respect of equity shares of unlisted company should not exceed the price arrived at on the basis of Return on Equity ("**RoE**") as per the last audited balance sheet.
- The formula is divorced from the traditional form of calculating RoE (where the denominator is average shareholder equity and not networth) and brings in several impractical situations set out below.
- Plain reading of the provision suggests that the exit price would be capped at the RoE. Whilst it is not clear, it appears that the RoE formula should be interpreted to mean principal plus the RoE. That is to say, if the invested amount was INR 100, and the company generated profits of INR 20 each year for five years, leading to a hypothetical net worth of 200, the RoE would be equal to the profits of the sixth year divided by 200. If the profit after tax in the sixth year were INR 20, the RoE would be 20/200 or 10%. Accordingly, the exit price for the foreign investor would be capped at INR 110, which clearly may not be reflective of the FMV of the instrument.
- The formula for determining the exit price seems to be at complete odds with the pricing suggested for convertibles (any internationally accepted valuation methodology), listed equity shares (ruling market price), or even shares and convertibles without optionality attached (discounted cash flow valuation), which are likely to be much closer to FMV than the RoE methodology.
- For instance, if the formula is applied, accumulated profits only decrease the RoE. The formula also leaves the exit price contingent on the last audited balance sheet, which may have unintended and distortionary consequences. For example, if the put option is to be triggered after a fixed period of time (being five years, in the above example), and the company incurs a loss in the sixth year, on a conservative basis, the exit price may be capped at a price lower than the investment amount.
- If the put option is tied to an event of default, the valuation mechanism may have unintended consequences as the default may have an impact on the profitability of the company in the year of exit.
- Requiring an exit at RoE is clearly ambiguous. Ideally the RoE can only be the basis to compute the exit price. To that extent, it remains to be seen if the RBI will permit the exit price on equity shares with optionality attached to be a variable of the RoE that brings the exit price closer to FMV, just as in case of convertibles and listed shares

4. *Determination of price of convertibles securities*

- The Amendment provides the exit price for convertibles upon exercise of put option should be a price determined based on international accepted pricing methodology, as determined by a SEBI registered merchant banker or chartered accountant.
- This valuation mechanism is likely to provide more flexibility to investors at the point of exit, and hence going forward we may see investors preferring more of convertible securities as compared to equity shares for their investments in Indian companies. Having said this, it is unclear why different valuation mechanisms were

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- believed to be required for equity shares and compulsorily convertible securities, which are in any case treated on the same footing and subject to DCF cap on an as if converted basis under the current regulatory regime.

5. *Status of existing option arrangements*

- The Circular clearly sets out that all existing contracts must comply with the conditions set out in the Amendment to qualify as being FDI compliant.
- In light of this, a position could be taken that all existing contracts that are not compliant with the conditions set out in the Amendment become FDI non-compliant, especially if they provide for options with assured returns.
- The terms of such put options contained in existing contracts may need to be revisited to bring them in compliance with the Amendment. However, if the existing terms of issuance already provide that the exit price should be subject to applicable law, then the terms of the security may be considered to have been amended by the law and should thus be considered valid notwithstanding the Amendment.

6. Impact on joint ventures and M&A deals

- Options are not just contained in private equity transactions. Even joint venture transactions and sometimes M&A transactions contain put options in favour of non-residents. These options are usually pegged to fair market value (determined per commercial negotiations) or at discount or premium to the fair market value.
- There may be a need to look at such joint venture agreements, as the commercially negotiated price will now be subjected to the pricing for options as set out in the Amendment.

CONCLUSION

The Amendment is a welcome development as it gives predictability and commercial flexibility to foreign investors, in relation to contractual provisions, which are fairly standard in the international investment context. However, pegging the exit price for equity to RoE (and not a multiple of RoE that brings the exit price closer to FMV) is likely to be a cause of major concern for investors. While preference shares may be preferred from an exit pricing perspective, Companies Act 2013, which denies the flexibility of voting on as-if-converted basis may galvanize the investors to invest in common equity. The need to amend existing contracts to bring them in line with the Amendment may be a challenging task, especially for most offshore private equity players that would be hesitant to revisit investment agreements if they are close to their exit horizons. What will also be interesting is to see how the term ‘exercise’ is interpreted and whether RBI will require exit pricing as set out for options to be applicable even when the shares are transferred to the Indian resident granting the option voluntarily, and not in exercise of the option/right.

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You can direct your queries or comments to the authors

[1] RBI Circular No. RBI/2013-2014/436 A.P. (DIR Series) Circular No. 86 (January 09 2013) available at: http://rbidocs.rbi.org.in/rdocs/Notification/PDFs/APDIR0901201486EN.pdf

[2] SEBI Notification No. LAD-NRO/GN/2013-14/26/6667 (October 03, 2013) available at: http://www.sebi.gov.in/cms/sebi_data/attachdocs/1380791858733.pdf