

Corpsec Hotline

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RBI ACTS SANTA FOR FCCB ISSUERS – PERMITS FCCB BUYBACK

With dismal share valuations causing bondholders to redeem, and not convert, their Foreign Currency Convertible Bonds (“FCCBs”), 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 issuing companies (“Issuers”). The liquidity crunch and the redemption pressure on the Issuers has caused the Reserve Bank of India (“RBI”) to finally step in and liberalize the highly regulated FCCB buyback. A recent circular issued by the RBI permits FCCB buyback until March 2009 not only under the automatic route, but also out of internal accruals to ease the redemption pressure which now looms large on India Inc. as redemption dates of few of these FCCBs approach in 2009.

This Hotline attempts to throw light on the popularity of FCCBs, their implications on Issuers in light of the recent financial meltdown, and finally analyses the recent policy changes introduced by the RBI to permit buyback of FCCBs at a discount.

What are FCCBs

FCCBs, or convertibles as they are more commonly referred to, are foreign currency denominated bonds subscribed to by non residents which can either be converted into equity shares of the Issuers or redeemed at a stipulated premium, if any.

FCCBs were popular amidst both the issuers and the bondholders for the advantages the instrument offered to both. To an Issuer, FCCBs offered low cost debt with minimal coupon rates as the value of the FCCB was not seen in the coupon rate offered, but the underlying shares of the company. To a bondholder, FCCBs offered the flexibility to convert into and outperform the underlying equity shares in adverse market situations due to the assured returns (coupon payment) and perform just as good as or even better than the underlying shares in a bullish market.

Impact of Financial Meltdown on FCCBs

As it happened, companies in their stride to access the global capital markets for low cost debt financing issued FCCBs at relatively high conversion prices (premium) to make the offering more attractive. The conversion prices were probably based on the assumption that share prices will continue to soar and bondholders will naturally opt for conversion instead of redemption.

However, with the recent financial meltdown which sent markets plummeting, these assumptions appear to have clearly misfired as bondholders now prefer to redeem their FCCBs as conversion into equity at current share valuations appears preposterous. For instance, Wockhardt which raised USD 110 million by way of FCCBs in October 2004 at a conversion price of Rs. 486 plus an interest of 5.25% per year is currently trading at Rs. 96.55. With redemption due in October 2009, bondholder will naturally opt for redemption which will make him richer by Rs. 629 per share as against conversion into equity shares at a mere Rs. 96.55 per share as per current valuations.

Buyback of FCCBs – Tracking policy changes

In light of the global financial slowdown, RBI in its press release dated November 15, 2008 announced that it will consider proposals for FCCB buyback under the approval route if funding for such buyback is financed either out of (i) existing foreign currency resources of the company held in India or abroad; or (ii) fresh external commercial borrowings (“ECB”).

RBI's move, however, lacked the flavor on at least the following three counts (i) most Issuers had limited financial

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resources overseas; (ii) the ongoing credit crunch made it impossible for Issuers to procure fresh ECB, particularly for discharge of existing debt; and most importantly (iii) buyback still required prior permission of the RBI which is not only discretionary, but time consuming as well. Need was therefore felt to permit FCCB buyback on the automatic route, preferably out of rupee proceeds. In fact, the RBI did permit buyback of FCCBs out of local resources for a limited time period in 2003.

In light of the above, the RBI in an attempt to further liberalize the FCCB buyback notified the norms for prepayment / buyback of FCCBs on December 8, 2008 vide AP (DIR) Circular No. 39 ("**Circular**") which not only provides for FCCB buyback under the automatic route but also permit use of rupee proceeds for buyback subject to certain conditions described herein below.

Automatic Route

Issuers can buyback FCCB without prior permission of the RBI if --

- (a) the buyback of FCCB is done at a discount of at least 15% on the book value; and
- (b) funding for such buyback is financed either out of
 1. existing foreign currency funds held either in India (including funds held in EEFC account) or abroad; and/or
 2. fresh ECB raised in conformity with the current ECB norms. If the fresh ECB is co-terminus with the residual maturity of the original FCCB but is less than three years, the all-in-cost ceiling should not exceed 6 months Libor plus 200 bps, as applicable to short-term borrowing.

Approval Route

Issuers can now buyback FCCBs out of internal accruals subject to prior approval of the RBI and fulfillment of the following:

- (a) the buyback value of the FCCB is done at a minimum discount of 25 per cent on the book value;
- (b) the funds used for the buyback are out of internal accruals, to be evidenced by Statutory Auditor and designated AD Category – I bank's certificate; and
- (c) the total amount of buyback does not exceed USD 50 million of the redemption value per company.

Few other key conditions for FCCBs buyback as stipulated in the Circular are as follows:

1. **Limited Period:** The provision of FCCB buyback is only available to Issuers until March 31, 2009, and accordingly the existing condition of minimum maturity period of 5 years in case of FCCBs has been put on hold until then.
2. **Right of buyback:** The right of buyback is vested with the Issuer and not with the bondholder, though consent of the bondholder will be required to effect the buyback.
3. **Escrow Account:** Issuers are required to open an escrow account with the branch or subsidiary of an Indian bank overseas or an international bank to ensure that the funds are used only for the buyback.

Conclusion

In the current financial turmoil where maintaining liquidity is critical, RBI's idea behind such relaxation is clearly to capitalize on the liquidity crunch of the bondholders who may prefer to forego the redemption premium due to them at a later date and offer their FCCBs for immediate sale, thereby protecting the economy by mitigating forex outflow.

Source: <http://rbidocs.rbi.org.in/rdocs/notification/PDFs/88805.pdf>

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