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Foreign investors' stake buy plan in unlisted cos may hit price bar

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MUMBAI: Many foreign investors eyeing stakes in closely held Indian firms as well as those looking to convert millions of dollars worth securities they bought a few years ago may face a price hurdle.

In a move that will make local unlisted firms expensive to offshore investors, the government has tweaked the foreign exchange law to change the way such companies are valued.

Till now when an Indian firm issued shares to a foreign investor, the deal price had to be above a floor rate defined by an old rule. Now, a new rule will significantly raise this minimum price. Moreover, the Reserve Bank of India will soon announce that the new floor price will also apply to secondary stake sale by local promoters and other resident shareholders to foreign investors. "The new valuation norms will discourage free pricing negotiations between parties and could be detrimental to private equity players," said Punit Shah, KPMG’s financial Services tax leader.

Currently, the minimum price is roughly the average of a company’s book value and its ability to earn profits in future; in investment banking parlance it’s PECV, or the profit earning capacity value. But under the new norm, a company will be valued by the discounted cash flow (DCF) method; here, a company’s cash flow is predicted for the next 5-10 years and then discounted at a rate to calculate the present value of the firm. Factors, such as inflation and cost of capital are used to fix the discounting rate.

Deal makers think that while DCF is a more scientific way to value a firm, it is certainly not the only way. “PECF is outdated and has been around for more than a decade. But one should also understand that each business is different, and DCF may not always generate a fair value. For instance, airlines bleed initially and may take years to generate a positive cash flow. Also, IT firms have a lot of intangibles and DCF cannot be used to arrive at a fair value,” said Siddharth Shah who heads the funds practice group at the law firm Nishith Desai Associates. According to Dilip Thakkar, an expert on FEMA, the new valuation benchmark could discourage foreign direct investment.

For convertible instruments, specially those where the conversion price is not predetermined, the new floor price rule will apply. Consider a case where a real estate firm sold a compulsorily convertible debenture to a foreign fund in 2007 at Rs 100 a piece. After a three-year lock-in, when the instrument comes up for conversion this year, the number of shares the investor will receive on conversion will depend on the floor price based on DCF.

If this price is Rs 50 the investor will receive two shares against each debenture. But if the fair value, according to the internal parameters and other valuation considerations agreed between the buyer and the seller, is Rs 33, then this price cannot be used to convert the debenture into three shares. Thus, the investor has to be satisfied with 2 shares. However, in instruments where the conversion price is prefixed, RBI is likely to allow the conversion at the agreed rate. Securities worth billions of dollars will come up for conversion in the next 18 months.

According to a gazette notification issued last week, the fair value (as per the DCF method) has to be done by a Sebi registered Category I merchant banker or a chartered accountant. Technically, the DCF floor price can be artificially lowered by taking a high rate to discount the future cash flow. But this can be risky. “RBI can question an unusually high discounting rate and the valuer will have a tough time justifying it,” says Shah.

But more that the change in valuation methodology, investors are questioning the restrictive nature of the guidelines. “Investment don’t happen just on the basis on financials. A lot of other factors such as business plan, growth and the quality of management go into a deal...The change in the Foreign Exchange Management Regulations could shake the foundations of venture capital funding,” feels Mahendra Swarup, president of Indian Venture Capital Association. Last week Swarup met senior RBI officials to discuss the issue.