

M&A Hotline

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RBI REVISES PRICING NORMS FOR FOREIGN INVESTMENTS

The Reserve Bank of India has revised the pricing guidelines for foreign investments into India and attendant repatriations. The revised pricing norms which prescribe the use of 'discounted free cash flows method', instead of the earlier past performance based 'ex-CCI valuation', are likely to make investments into Indian companies more expensive.

The Reserve Bank of India ("RBI") vide notification no. FEMA 205/2010-RB, dated April 7, 2010¹(the "Notification") had amended Regulation 6 (pertaining to rights issue) and Schedule 1 (foreign direct investment scheme) of the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("TISPRO Regulations") setting out revised pricing norms at which shares² of Indian companies can be issued to non-residents. Now, vide A.P. (DIR Series) Circular No. 49 ("Circular") dated May 4, 2010, the RBI has revised the pricing guidelines for transfer of shares from a resident to a non-resident and vice-versa and notified the pricing norms with respect to issue of shares to non-residents.

This Hotline discusses the background and the changes brought about by both the Notification and the Circular ("the Amendments") and analyzes their implications on foreign investments.

BACKGROUND

Prior to the Amendments, any issue or transfer of unlisted shares to persons resident outside India was based on the "ex-CCI valuation" i.e. price determined in accordance with the guidelines issued by the erstwhile Controller of Capital Issues for valuation of shares in 1990. Under these guidelines (as were adopted by the RBI) the minimum price to be paid by the non-resident to the resident had to be atleast the average of the Net Asset Value ("NAV") and the Profit Earning Capacity Value ("PECV") of the company.

Since the ex-CCI valuation was driven by the past performance of the company, a need for a valuation system that took into account future performance of the company was felt, to arrive at the fair value. To that extent, the Amendments have revised the pricing norms for issuance and transfer of shares to a relatively more progressive discounted free cash flow ("DCF") method for unlisted shares.

CHANGES INTRODUCED BY THE AMENDMENTS:

1. Listed Company

Type of Issue	Previous framework	Revised Framework
Issue of shares	The price of shares should not have been lower than the price arrived at as per the applicable Securities and Exchange Board of India ("SEBI") guidelines.	No change.
Rights Issue	The offer on right basis to persons resident outside India should not have been lower than the price at which the offer is made to resident shareholders.	The offer on right basis should be at a price as determined by the company.
Preferential Allotment	No separate category of preferential allotment existed. Shares were issued in line with norms applicable to issuance of shares.	A new category of preferential allotment has been created. Price of shares issued on preferential allotment should not be lower than the price as applicable to transfer of shares from residents to non-residents. This pricing norm is given hereinafter.
Transfer by resident to non-resident (i.e. to foreign	The transfer by way of sale should have been at a price not less than the ruling market price.	The price of shares transferred by way of sale should not be less than the price at

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national, Non-Resident Indian ("NRI"), Foreign Institutional Investor ("FI") and incorporated non-resident entity other than erstwhile Overseas Corporate Body ("OCB"))

which a preferential allotment of shares can be made under the SEBI guidelines³, as applicable, provided that the same is determined for such duration as specified therein, preceding the relevant date, which shall be the date of purchase or sale of shares ("Preferential Allotment Price").

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Transfer by non-resident (i.e. by incorporated non-resident entity, erstwhile OCB, foreign national, NRI, FI) to resident.

Where the shares of an Indian company were traded on stock exchange:

A. If the sale was effected through a merchant banker registered with the SEBI or through a stock broker registered with the stock exchange, the price should have been the prevailing market price on stock exchange;

B. If the transfer was other than that referred to in clause A above, the price should have been arrived at by taking the average quotations (average of daily high and low) for one week preceding the date of application with 5% variation.

Where, however, the shares were being sold by the foreign collaborator or the foreign promoter of the Indian company to the existing promoters in India with the objective of passing management control in favour of the resident promoters the proposal for sale would have been considered at a price which could be higher by up to a ceiling of 25% over the price arrived at as above.

Where the shares of the company were thinly traded⁴, the pricing norms of unlisted companies were applicable.

2. Unlisted Company

Type of Issue	Previous framework	Revised Framework
Issue of shares	Price of shares should not have been lower than the fair valuation arrived at by a Chartered Accountant ("CA") as per ex-CCI valuation.	Price of shares should not be lower than the fair valuation done by a SEBI registered Category-1 Merchant Banker ("MB") or a CA as per the DCF method.
Rights Issue	The offer on right basis to the persons resident outside India should have been at a price which is not lower than that at which the offer is made to resident shareholders.	No change.
Preferential Allotment	No separate category of preferential allotment existed. Shares were issued in line with norms applicable to issuance of shares.	A new category of preferential allotment has been created. Price of shares issued on preferential allotment should not be lower than the price as applicable to transfer of shares from residents to non-residents. This pricing norm is given hereinbelow.
Transfer by resident to non-resident	The price of shares should not have been lower than the fair valuation done by a CA as per ex-CCI valuation.	The transfer of shares should be at a price not less than the fair value to be determined by a MB or a CA as per the DCF method.
Transfer by non-resident to resident.	Where the shares of an Indian company were not listed on stock exchange or were thinly traded, (i) if the consideration payable for the transfer did not exceed INR 2 million (approximately USD 43,850) per seller per	The transfer of shares should be at a price not more than the fair value to be determined by a MB or a CA as per the DCF method.

company, at a price mutually agreed to between the seller and the buyer, based on any valuation methodology currently in vogue, on submission of a certificate from the statutory auditors of the Indian company whose shares are proposed to be transferred, regarding the valuation of the shares, and

(ii) if the amount of consideration payable for the transfer exceeded INR 2 million per seller per company, the transfer could be at a price arrived at, at the seller's option, in any of the following manner, namely:

A) a price based on earning per share ("EPS") linked to the Price Earning (P/E) multiple, or a price based on the NAV linked to book value multiple, whichever was higher, or

B) the prevailing market price in small lots as may have been laid down by the RBI so that the entire shareholding was sold in not less than five trading days through screen based trading system, or

C) where the shares were not listed on any stock exchange, at a price which was lower of the two independent valuations of share, one by statutory auditors of the company and the other by a CA or by a MB.

ANALYSIS AND IMPLICATIONS

The key implications arising out of the Amendments are:

- **Valuation restricted to DCF:** Stipulating specific pricing parameters for valuing a company may hinder the determination of fair value of the company as these parameters vary across different sectors and industries. Typically, for arriving at fair valuation, the valuers may use various approaches like the income approach, the asset approach, the market comparables approach or a combination of them. By limiting the valuation to the DCF method, which is premised on the future cash flows of the company, the RBI has restricted the recourse to the other approaches, which may be more appropriate in certain cases. Furthermore, the DCF method may return a value which may turn out to be higher than that arrived on commercial valuation.
- **Rights issue pricing for listed shares:** Pricing norms for rights issue of listed securities have been left at the discretion of the issuer company. Since, (i) generally a rights issue is offered to all the shareholders of the company at the same price, and (ii) earlier too, there were no specific pricing guidelines prescribed for a rights issue to non-residents, except that it should not have been at a price lower than the price offered to residents; the purpose of the change and reason behind differentiating between listed and unlisted shares is unclear.
- **Preferential Allotment of shares:** The Amendments have created a new category of 'preferential allotment', which did not exist earlier. Preferential allotments were treated just like issuance of shares to non-residents. However, the Amendments have stipulated that preferential allotments should be made at a price that is applicable to transfer of shares from residents to non-residents. To that extent, preferential allotments for unlisted shares will be governed by the DCF method, and for listed shares the Preferential Allotment Price may apply. As the pricing for 'preferential allotments' and issuance of shares is similar, the rationale behind creating the distinction between the two remains to be seen.
- **Transfer of listed shares from residents to non-residents:** The pricing norms for transfer of listed shares from residents to non-residents have been changed from the ruling market price to the Preferential Allotment Price. By doing so, the RBI seeks to bring the pricing norms applicable to transfer of listed shares in consistency with the SEBI pricing guidelines. This is likely to deter manipulation of prices as Preferential Allotment Price will be less susceptible to manipulation as against the ruling market price.
- **Transfer of listed shares from non-residents to residents:** Earlier, 5% variation from the pricing norms was permitted for transfers of listed shares other than on the stock exchange. For transfer of shares to existing Indian promoters with the object of passing management control, a flexibility of 25% over the prescribed price was provided for. However, with all listed shares now being required to be transferred at not more than the Preferential Allotment Price, the flexibility to pay control premium to foreign promoters/collaborators has been withdrawn, and even such transfers have been equated with other transfers.
- **Preferential Allotment Price for shares listed for less than six months:** For transfer of shares by residents to non-residents and vice-versa, the RBI has prescribed Preferential Allotment Price. In cases where the equity shares of the issuer have been listed for a period of less than six months as on the relevant date, the SEBI guidelines mandate recomputation of price on completion of six months from the date of listing. If such recomputed price turns out to be higher than the price paid on allotment, the difference shall have to be paid by the allottees to the issuer. To that extent, dealing in shares that are listed for less than six months, may need to be structured carefully.
- **Thinly traded shares:** The RBI has removed the category of thinly traded shares. Earlier, for the purpose of pricing norms, there was a separate classification of thinly traded shares and these were clubbed with unlisted shares. But, now this distinction has been done away with and the pricing norms applicable to listed shares have been made applicable to all listed companies, irrespective of whether they are thinly traded or not. Accordingly, for shares of the company being negligibly traded, the Preferential Allotment Price may not reflect the fair value of the stock.

· *Specific valuation for transfers below INR 2 million:* All transfers now, whether below INR 2 million or not, will now be monitored. Prior to the Amendments, if the consideration payable for the transfer did not exceed INR 2 million per seller per company, the transfer could be based on any valuation methodology in vogue then. All that was required was, submission of a certificate regarding the valuation of shares from the statutory auditors of the Indian company whose shares were proposed to be transferred. But now, for such transfers as well the DCF method has been introduced. As such, these transactions may become more expensive.

· *Only one valuer for transfers of unlisted shares from non-residents to residents:* For transfers by non-residents to residents valued above INR 2 million, the sellers were vested with multiple options. But more often than not, it was common for them to procure two independent valuations of share, one by statutory auditors of the company and the other by a CA or a MB. The reason for this was natural as the other valuation methods based on higher of the EPS (linked to the P/E multiple) or the NAV (linked to book value multiple) generally returned a lower valuation. By doing away with all the options and adopting one single DCF method for all the transfers, the RBI has made the provisions much simpler and has synced it with the entry pricing norm.

· *Intangible and share premium:* The earlier, ex-CCI valuation did not take into account the share premium to be infused by the non-resident. Neither, did it consider the intangibles while valuing the company. But, with the DCF method, the entire cash flows, including not only the share premium, but in effect, the intangibles as well, will be used for the purpose of valuation.

· *Cascading effect:* Consolidated FDI Policy mandates downstream investments by Indian companies either 'owned' or 'controlled' by non-resident entities should comply with the applicable pricing and valuation guidelines issued by the SEBI and the RBI. To that extent, the revised pricing norms will also apply to investments made by foreign owned or controlled companies in downstream companies.

CONCLUSION

The Amendments make the pricing norms much simpler by adopting just two norms – Preferential Allotment Price for listed companies and DCF method for unlisted companies.

Whilst the shift to Preferential Allotment Price is likely to deter price manipulations that could have been possible with ruling market price, it is the shift to the DCF method from the ex-CCI valuation that is likely to make a more significant impact.

Though, the DCF method may be regarded as closer to fair valuation to the extent that it takes into account the future performance as well, it may not be the best possible methodology to arrive at fair valuation. Typically, as mentioned above, a valuer would take recourse to a combination of the income approach, the assets approach or the market comparables approach to arrive at the fair value. But DCF method will restrict the valuer from basing his valuations on the assets approach or the market comparables approach. This becomes important especially when we deal with industries with long gestation periods, or for distressed companies which have huge assets in their books but do not anticipate any future cash flows.

Implications of the Amendments may have an impact on financial investors as they may have to invest at the DCF value which is close to realizable value, or maybe even higher value, making the local companies relatively more expensive. Even though no parameters have been stipulated for calculation of the DCF value, severe discounting of cash flows to lower the floor price may not be seen favorably by the RBI, if not supported by adequate justification.

Whilst the Amendments intend to ensure that the value of Indian business that gets transferred outside of India is not less than the consideration received, the implications of the Amendments on foreign investments and attendant repatriations remain to be seen.

- Deepak Jodhani, Richie Sancheti & Ruchir Sinha

¹ Effective from April 21, 2010 (the date of publication in the Official Gazette of India).

² Shares are generally referred to equity shares and fully and mandatorily convertible preference shares and fully and mandatorily convertible debentures.

³ Regulation 76 of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009: (1) If the equity shares of the issuer have been listed on a recognised stock exchange for a period of six months or more as on the relevant date, the equity shares shall be allotted at a price not less than higher of the following:

(a) The average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during the six months preceding the relevant date; or

(b) The average of the weekly high and low of the closing prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

(2) If the equity shares of the issuer have been listed on a recognised stock exchange for a period of less than six months as on the relevant date, the equity shares shall be allotted at a price not less than the higher of the following:

(a) the price at which equity shares were issued by the issuer in its initial public offer or the value per share arrived at in a scheme of arrangement under sections 391 to 394 of the Companies Act, 1956, pursuant to which the equity shares of the issuer were listed, as the case may be; or

(b) the average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during the period shares have been listed preceding the relevant date; or

(c) the average of the weekly high and low of the closing prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

(3) Where the price of the equity shares is determined in terms of sub-regulation (2), such price shall be recomputed by the issuer on completion of six months from the date of listing on a recognised stock exchange with reference to the average of the weekly high and low of the closing prices of the related equity shares quoted on the recognised stock exchange during these six months and if such recomputed price is higher than the price paid on allotment, the difference shall be paid by the allottees to the issuer.

⁴ A share is considered as thinly traded if the annualized trading turnover in that share, on main stock exchanges in India, during the six calendar months preceding the month in which application is made, is less than 2 percent (by number of shares) of the listed stock.

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