Corpsec Hotline

May 22, 2007

TOWNSHIP PROJECTS CANNOT BORROW FROM OVERSEAS

The Government of India in consultation with the Reserve Bank of India ("**RBI**"), has limited the use of External Commercial Borrowings ("**ECB**"), by removing "development of integrated townships" as a permitted end-use under the ECB guidelines. Further the all-in-cost ceilings for the amounts payable to the lenders for the ECB (which includes interest) have been reduced by 50-100 basis points ("**bps**"). The RBI has as of May 21, 2007 issued the relevant notification under the Foreign Exchange Management Act.

Background

As per the extant ECB guidelines, ECB proceeds may be utilised only for permitted end-use, which is primarily directed towards capital expansion or overseas acquisitions. Real estate is expressly prohibited as an end-use for ECB, however the term "real estate" in the ECB guidelines was defined to *exclude* "development of integrated townships" as defined by Press Note 3 (2002 Series) dated January 04, 2002 issued by Ministry of Commerce & Industry. The aforesaid Press Note 3 defined "development of integrated townships" as *inter-alia* including housing, commercial premises, hotels, resorts etc. Further conditions were also imposed such as a minimum area requirement of 100 acres, a minimum capitalisation and a minimum lock-in period for repatriation of original investment.

The notification by the RBI pursuant to the Government's press release has withdrawn the exemption accorded to the "development of integrated township" as a permissible end-use under the ECB guidelines.

The all-in-cost ceilings (the upper limit of the cost) for borrowings with 3-5 year minimum average maturity period has been lowered to the rate of 150 bps above the benchmark 6 month LIBOR , against 200 bps at present. Further for borrowings with a minimum average maturity period greater than 5 years the rate has been lowered to 250 bps over the 6 month LIBOR, as against 350 bps currently.

Analysis and Implications

The decision to prohibit Indian companies from utilising debt raised under the ECB guidelines for developing integrated townships seems to be aimed at curbing the inflow of foreign capital into the real estate sector. It is believed that the RBI and the Government, fear the build up of an asset bubble in the Indian real estate sector, due to the heightened interest of foreign investors and the consequent sky-high property valuations. Further the recent steady appreciation of the rupee compounded with a spurt in the inflation may have motivated the government decision to curb the surge of foreign investment.

It is interesting to note that this move has been quick on the heels of an earlier press release dated April 30, 2007 which characterised foreign investments in Indian companies in the form of preference shares, other than compulsorily convertible preference shares issued on or after May 1, 2007, as ECB and not foreign direct investment ("**FDI**") and therefore issuance or transfer of the same would be subject to the terms and conditions of the ECB guidelines (please refer to our hotline on the same). Traditionally FDI in to the real estate sector, like investments in other sectors, was structured as quasi-equity in the form of preference shares (optionally convertible, non-convertible or partially convertible preference shares) as this brought fixed returns and an option to convert into equity. This was considered ideal for the real estate sector as long gestation periods; various regulatory approval risks made equity investments a high risk proposition. Further as the ECB guidelines prohibited real estate purchase or development as an end-use, the use of preference shares were the only instruments which could provide debt like seniority and assured returns during the gestation period of the project.

With the above mentioned restrictions on structuring of FDI as preference share, the latest press release modifying the ECB guidelines is seen as a further blow to foreign investments in to the real estate sector effectively curtailing all forms of debt or quasi-equity investments in the real estate sector.

However, companies may now be able to tap ECBs at lower rates of interest due to the reduction in the all-in ceiling costs for ECBs by 50-100 bps . The downward revisions in

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the existing all-in-cost ceilings, has been ostensibly stated as in view of the upgrading of the country's sovereign credit ratings.

As per the notification the changes will apply to ECBs both under the automatic and approval routes.

Sources:

- A. P. (DIR Series) Circular No. 60 "External Commercial Borrowings (ECB) – End-use and All-in-cost ceilings - Revised"
- Press release – ECB policy modified
- Press release - Guidelines for Foreign Investment in Preference Shares

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