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New FDI policy on convertibles hits private equity deal-making

Reghu Balakrishnan / January 13, 2011, 0:10 IST

PEs confused over fixing conversion price and ratio fixed upfront.

Apart from high valuations, the foreign direct investment (FDI) policy on convertible instruments is delaying private equity/venture capital deals in India. Experts say PE/VC deals routed through compulsory convertible preference shares (CCPS) or compulsory convertible debentures (CCDs) have been delayed indefinitely due to ambiguity over the new policy, introduced last year.

The Department of Industrial Policy & Promotion (DIPP) and the commerce ministry issued a circular dated March 31, 2010, on FDI policy. Later, the Reserve Bank of India stipulated that as on April 7, the pricing of all convertible instruments issued to offshore investors must be done upfront at the time of issuance, without leaving any room for adjustment at the time of conversion, even if this is in compliance with the applicable pricing guidelines.

Siddharth Shah, head, corporate and securities practice at Nishith Desai Associates, said, “The change in the FDI policy introduced on April 1, 2010, has created one of the biggest hurdles for PE deal-making in India. Convertibles — which are the most favoured by VC/PE investors the world over as they bridge the valuation gap between promoters and investors and offer a flexible instrument to reward promoters for performance — have been made complicated. This is because the conversion price and ratio are now required to be fixed upfront. So, conversion of a CCPS or a CCD issued to an investor which is linked to the company’s future performance is now not possible.”

In one of the largest of PE deals last year, Asian Genco sold stake through convertible instruments that would give around 44 per cent stake to investors, including Morgan Stanley, Everstone Capital, General Atlantic, Goldman Sachs and Norwest Venture Partners, in a deal worth $450 million. Recent deals involving convertible instruments include JFE Holdings Inc’s investment in JSW Steel Ltd, AAA Project Ventures’ investment in Reliance Infrastructure, Temasek Holdings Advisors’ investment in GMR Energy Ltd and Blackstone Group’s Rs 300-crore investment in GatewayRail Freight Ltd (to buy 37 per cent stake) in 2009.

Nitin Deshmukh, CEO, private equity, Kotak Investment Advisors, said, “VC/PE investors typically use performance measures to link returns to the success of the company. Removing the ability of VC/PE investors to use such measures unnecessarily handcuffs them. Further, since RBI’s position on this matter was issued as a ‘clarification’, the position of existing offshore investors holding convertible instruments subject to further adjustment is not clear.”

Roshan Thomas, a partner at Lexygen, said, “The language of DIPP, though innocuous enough, lends itself to a fair amount of ambiguity and causes confusion. It is not clear whether the parties have to agree upon a numerical conversion price upfront or it is sufficient to agree upon a conversion formula.”

Adding: “If the regulatory authorities’ view is that a numerical conversion price must be fixed upfront, investors will not even be able to use convertible instruments for valuation adjustments. This will make convertible instruments rather unattractive.”

Since 2007, convertible instruments required to be mandatorily converted are be treated as FDI, effectively putting an end to the downside protection afforded to investors to require redemption of such instruments.

Shah added, “Measures such as these will make India a difficult place to invest for PEs, which have clearly emerged as one of the largest investors in India. Policymakers need to recognise that India is no longer competing with just the emerging economies, but equally with developed economies, which also offer compelling investment opportunities. Any hurdles we create to this flow of PE capital will definitely and very silently divert it to other competing economies.”