

Capital Markets Hotline

November 27, 2013

INDIAN UNLISTED COMPANIES ALLOWED TO LIST INTERNATIONALLY: ANOTHER EXIT ROUTE FOR INVESTORS?

- Unlisted companies allowed to issue ADRs/ GDRs without the requirement of prior, simultaneous or subsequent listing on Indian stock exchanges;
- Relaxation for a limited period of two years only, as of now;
- Capital raised may be used for offshore purposes; else must be repatriated to India for domestic purposes, within 15 days.

The Ministry of Finance (“**MoF**”) through a press release dated September 27, 2013 (“**Press Release**”)¹, has permitted unlisted Indian companies to list directly on offshore stock exchanges without prior or simultaneous or subsequent listing in India, which was not permitted earlier. This move comes in the backdrop of relatively weak domestic capital markets with very few successful Initial Public Offers (“**IPOs**”) of Indian companies in recent times and India’s increasing current account deficit. The MoF has permitted Indian unlisted companies to list their American depository receipts (“**ADR**”) global depository receipts (“**GDR**”) or foreign currency convertible bonds (“**FCCB**”) abroad on a pilot basis for two years without a listing requirement in India.

Consequent to the Press Release, the Central Government in its notification dated October 11, 2013 (“**Notification**”)² amended the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depositary Receipt Mechanism) Scheme, 1993 (“**Scheme**”). The Reserve Bank of India (“**RBI**”) has now followed this up with a circular dated November 8, 2013 (“**Circular**”)³ directing the authorized dealers towards the amendment to the Scheme.

BACKGROUND

In the year 2005, the MoF disallowed issuance of GDRs without listing in India. Before such restriction was imposed, companies such as Sify, Satyam Infoway and Rediff raised substantial amount of funds through listing their GDRs/FCCBs in foreign stock exchanges and continue to remain to be unlisted in India.

The Securities Exchange Board of India (“**SEBI**”) supported this move since it believed that it would help the development of domestic capital markets and shall also give it regulatory control over companies issuing GDRs/FCCBs.

However, the poor performance of the domestic capital markets in recent years and the consequent impact on the market sentiment has made it difficult for companies to raise money from domestic capital market. In such a situation, Indian groups or their founders have started setting up offshore companies (that through their Indian subsidiary owned the Indian asset) and are solely dedicated towards raising funds abroad. These offshore companies were then listed on the back of their Indian subsidiary holding the Indian asset.

In this background, it seems the government has now decided to permit Indian unlisted companies to issue ADRs/ GDRs without the requirement to list in the domestic stock exchange.

AMENDMENT

The Notification has amended the regulation 3(1)(B) of the Scheme to permit Indian unlisted companies to issue GDRs/ FCCBs without having to fulfill the requirement of a simultaneous domestic listing.

Before the amendment, the regulation 3(1)(B) of the Scheme read as under:

“Unlisted Indian Companies issuing Global Depositary Receipts/Foreign Currency Convertible Bonds shall be required to simultaneously list in the Indian Stock Exchange(s).” (Emphasis added).

However, now this restriction has been removed and unlisted Indian companies issuing GDR/FCCB may raise capital abroad subject to the following conditions:

- The companies will be permitted to list on exchanges in IOSCO/FATF compliant jurisdictions or those jurisdictions with which SEBI has signed bilateral agreements (which are yet to be notified);
- The companies will have to comply with SEBI’s disclosure requirements in addition to that of the exchange where it is to be listed;
- A copy of return filed with the offshore exchange will also have to be filed with SEBI for the purposes of the Prevention of Money Laundering Act;
- The raising of capital abroad shall be in accordance with the extant foreign direct investment policy (“**FDI Policy**”), including the sectoral caps, entry route, minimum capitalization norms and pricing norms;

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- The number of underlying equity shares offered for issuance of ADRs/GDRs to be kept with the local custodian shall be determined upfront and ratio of ADRs/GDRs to equity shares shall be decided upfront based on applicable FDI pricing norms of equity shares of unlisted company;
- The unlisted Indian company shall comply with the instructions on downstream investment as notified by the Reserve Bank from time to time;
- The funds raised may be used for paying off overseas debt or for operations abroad, including for the funding of acquisitions;
- The criteria for eligibility of unlisted companies raising funds through ADR/ GDR shall be prescribed by the Government of India;
- In case the money raised in the offshore listing is not utilized overseas as described, it shall be remitted back to India within 15 days for domestic use and parked in AD category banks;
- The listing company shall report to RBI as prescribed under sub-paragraphs (2) and (3) of Paragraph 4 of Schedule 1 to FEMA Notification No. 20.

ANALYSIS

Offshore structures: It is expected that the change in law shall provide enough encouragement for Indian companies seeking funds from abroad to refrain from setting up offshore companies (that through their Indian subsidiary own the Indian asset) and Indian companies will directly be able to tap the offshore capital markets.

Compliance with the FDI policy: The fund-raising from abroad is required to be in compliance with the extant FDI Policy. The Scheme states that an investment made in a company through GDRs/FCCBs shall be treated as FDI and shall be restricted to 51% of the issued and subscribed share capital of the issuing company.⁴ The Scheme has to be read in conjunction with the FDI policy, and in effect even if FDI in a particular sector is permitted above 51%, investment by way of GDRs/FCCBs shall be restricted to only 51%.

[The specific requirement to comply with the guidelines on downstream investment will prevent such Indian companies from accessing this route of capital raising wherein the company has downstream investments in sectors prohibited for foreign investment, or such investment is in excess of the sectoral cap applicable to the sector in which the downstream investee company operates.]

Pricing: The Scheme states that pricing of offshore securities issued by unlisted companies shall be in accordance with the RBI regulations⁵. However the pricing norms under the FDI Policy shall not apply in case of transfers of GDRs between non-residents.

Disclosure requirements: The amendment clearly states that issuing companies are required to comply with disclosure requirements of the SEBI. The Notification mentions that the disclosure requirements are for the purposes of compliance with the Prevention of Money Laundering Act, 2002.

Raising for overseas purposes: The Notification states that the funds raised for '*retiring outstanding overseas debt or for bona fide operations abroad including for acquisitions*' shall have to repatriated to India and used for eligible uses, if the funds are not utilized within 15 days. While the intent seems to be to ensure that the funds, if raised for offshore purposes are not utilized for such bona fide purposes, it must not lie outside India, the period for the utilization seems to be rather short. To avail of the offshore utilization option provided, the company issuing the GDRs may have to structure the issuance in a manner that they are not forced to repatriate the funds to India on account of their inability to use such funds within a period of 15 days. For instance, the raising of funds for an acquisition offshore would practically be a challenge, considering that the funds will have to be utilized within 15 days of the listing.

The Notification mentions that the funds repatriated to India shall be used for domestic eligible purposes only as set out in the Scheme.

Pilot basis: The Notification, which amends the Scheme, mentions that unlisted companies shall be allowed to raise capital abroad '*without the requirement of prior or subsequent listing in India initially for a period of two years*'.

The intent of the changes seems to be to permit unlisted companies to issue GDRs/ FCCBs for a period of two years from the date of the Notification, after which the relaxation may be withdrawn. An unlisted company which avails of the relaxation may issue GDRs/ FCCBs multiple times during the two years for which the relaxation continues. However, a company not listed on a domestic stock exchange, including a company already having issued GDRs during this two year relaxation, and proposing to issue GDRs subsequent to such two year period will need to list in a domestic jurisdiction simultaneously or prior to the offshore listing.

However, the Press Release, as well as the Circular mentions that unlisted companies are being permitted to issue GDRs on a pilot basis for a period of two years from the date of notification of the change. According to the Press Release, it was proposed that the impact of the arrangement would be reviewed after the expiry of the two year period. The Circular mentions that the Scheme will be implemented subject to review after a period of two years. This has led to some ambiguity on the applicability of the changes and it remains to be seen whether following the review the scheme of allowing such offshore listings, without listing will be continue to be available to unlisted Indian companies.

While the relaxation of the requirement to list in a domestic exchange simultaneously is encouraging, it is important for the regulators to clarify that companies that list overseas under this route would be permitted to remain unlisted in domestic exchanges, even if the proposed relaxation is withdrawn later. In the absence of such a clarification, companies might be wary of the possibility that if the relaxation is withdrawn, they might be compelled to list on a domestic exchange within a given time frame. Therefore, the consequences of a possible withdrawal are required to be clarified beforehand so as to give an idea to issuing companies as well as investors and for them to be prepared accordingly.

IMPACT

Private Equity exits: Permitting Indian unlisted companies to list GDRs/FCCBs abroad is a welcome move for private equity ("PE") investors.

PE investors have a number of exit options in their investment agreements, IPOs being one of them. As many as 50

proposed IPOs have failed since January, 2011⁶. However, the year 2012 saw maximum PE exits by way of public offer largely because a number of IPOs of PE-backed companies which were deferred in 2011 proceeded to completion in the following year.⁷ Considering the uncertainty in relation to successful completion of IPOs, it has never been a very reliable exit route.

Certain jurisdictions are more favorable for certain sectors. For instance, information technology companies prefer NASDAQ or the NYSE while real estate companies have generally opted for SGX for listing.

This change would now enable PE investors to require their investee companies to list in jurisdictions that are favourable to the certain sector/ industry in which the investee company operates, thereby making IPO a potentially more viable exit option.

However, the PE investors that would be able to benefit from this relaxation may be limited. Since as of now, the relaxation is available only for a period of two years. The existing investments may not be able to benefit from this relaxation, unless the investment agreements permit offshore listing to be considered as "qualified IPOs" or unless such agreements are amended to this effect. On the other hand, fresh investors may not be able to benefit from the relaxation, unless the pilot scheme is extended beyond the two year period, because the proposed exit for investments being made in the next couple of years in most cases is likely to be beyond the two year period (of the relaxation).

In addition, the Notification permits Indian companies to 'raise capital' offshore without listing on Indian exchanges. This may lead to ambiguity as to whether this relaxation can be used for 'offers for sale' or whether the Indian companies must always 'raise capital' whenever they list overseas while relying on this relaxation..

Mitigation of currency risks: Investing in GDRs/FCCBs is preferable than directly holding shares in the Indian company that are denominated in Indian rupees. For instance, consider a financial investor who invested in Indian companies when the conversion rate of USD to Indian rupee was around INR 45 to USD 1. While the investee company may have been profitable and provided the investor with the expected returns, due to the increased conversion rate (say INR 55 to USD 1), a substantial portion of this profit would get wiped out, and resulted in losses to the investors. This potential risk of currency rate fluctuation is mitigated when the investor exits by selling GDRs/FCCBs denominated in USD.

Tax benefits: GDRs/FCCBs are specifically exempt from capital gains tax when a non-resident holder transfers GDRs/FCCBs to another non-resident.⁸ Even when the GDRs/FCCBs are converted into the underlying equity no capital gains tax arises.⁹ Hence investing GDRs/FCCBs may be a preferred route for non-resident financial investors who wish to have exposure to Indian companies as part of their investment portfolio.

CONCLUSION

These changes have the potential to have wide-reaching impact on unlisted Indian companies as well as on both domestic and foreign investors, by providing Indian companies new avenues to raise funds and exit options to PE investors, albeit in a limited manner, as discussed above, in such companies. Whilst the changes have come in at a time when the domestic markets continue to perform poorly and companies have been looking at alternate routes to raise funds and provide exits to their investors, issuing clarifications regarding issues identified above will lend greater certainty and encourage companies to seriously consider offshore capital listings.

Further, since the issuance of GDRs is subject to the SEBI disclosures, SEBI notification laying down the requisite disclosure requirements is awaited before this relaxation may be utilized by Indian companies.*

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You can direct your queries or comments to the authors

¹ The Press Release is available on: http://finmin.nic.in/press_room/2013/lisitIndianComp_abroad27092013.pdf

² Notification no. GSR 684(E) [F.NO.4/13/2012-ECB], dated 11-10-2013

³ RBI A.P. (Dir Series) Circular No. 69 of November 8, 2013

⁴ Regulation 4 of the FCCB Scheme

⁵ Regulation 5(4)(cb)

⁶ <http://www.deccanherald.com/content/250242/50-ipos>

⁷ India Private Equity Report 2013, Bain and Company, available at: http://www.bain.com/Images/BAIN_REPORT_India_Private_Equity_Report_2013.pdf

⁸ Section 47(via) of the Income Tax Act, 1961

⁹ Section 47(x) of the Income Tax Act, 1961

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