Regulatory changes without bite

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Close on the heels of the new consolidated FDI policy (which this column discussed last month), comes yet another regulatory change that is impacting deal-making in India with foreign money. The Reserve Bank of India (RBI) has, through a notification issued on 7 April and a circular dated 4 May, amended the manner in which cross-border share transfers and share issues are to be valued. We discuss below the valuation norms for unlisted companies. (For implications of these regulatory changes on M&A transactions, see page 53.)

The change

Any issue or transfer of shares of an Indian unlisted company by an Indian resident to a non-resident is subject to a minimum floor price. Similarly, any sale by a non-resident of shares of an Indian unlisted company to a resident is subject to a maximum price cap.

The RBI used to require that the price threshold for foreign investment inflows be the fair market value of the shares determined by a chartered accountant in accordance with the guidelines laid down by the erstwhile Controller of Capital Issues (CCI). These guidelines were issued in 1990 and the regulator has now replaced the CCI valuation method with the discounted free cash flow method (DCF), which is the preferred valuation norm globally.

The fixing of the price cap for exits by foreign investors by sale of shares to residents was thus far more flexible and no valuation method was prescribed. The only restriction was that the cap be the lower of two independent valuations – one conducted by the statutory auditors of the company and the other by a chartered accountant or a merchant banker. The recent amendment requires that DCF valuation be used for arriving at such caps as well.

The CCI guidelines valued companies on net present asset value and profit earning capacity value based on past performance. In contrast, the DCF method is forward looking as it takes into account projections of future cash flows.

Impact on deal flow

CCI valuations tended to be lower than market valuations and so were not generally impediments to foreign direct investment (FDI). By introducing the DCF method it appears the regulator hoped for a higher and more realistic pricing floor for investments in India.

This may not, however, be the case, as the RBI has not put forward any guidelines for DCF valuation. The manner of arriving at the discount rate, the period for which the cash flows are to be considered and most significantly, the cash flow projections and growth rate are completely unregulated for now.

This gives plenty of room for parties to work backwards from a pre-agreed benchmark and manipulate cash flow projections as desired. Therefore, it is unlikely that valuation based on the new norms will significantly impact inbound activity. For the same reason, investor exits are not likely to be greatly affected by the imposition of DCF valuation norms.

Although the investment community is not in general complaining, some, like the venture capitalists, are more concerned as this complicates valuation of start ups, with no present cash flows available for extrapolation and no historical patterns on which projections may be assessed.

Moreover, valuing a fledgling company based on the DCF method causes an unnecessary inflation of transaction costs, which companies looking for seed and venture capital can ill-afford. An alternate price fixing mechanism for such companies could have been considered. In fact, a wider range of valuation options, or a combination of methodologies may have been a preferred substitute for the one-size-fits-all norm that has been prescribed.

Unnecessary evil?

While most agree that the CCI guidelines were outdated, proponents of deregulation question the very need for pricing restrictions, arguing that they are opposed to the fundamentals of contract theory. The necessity for the government to interfere with the commercial wisdom of freely consenting parties is often criticized and price regulation is viewed as regressive.

The regulatory logic behind such controls is to prevent losses to the company and minority shareholders through deals where part consideration is routed directly to the promoters to prevent foreign exchange loss to the state resulting from less than fair market value consideration. However, given that the DCF method is as malleable as it is, the efficacy of the pricing constraint is questionable.

Pricing controls are likely to end up as a regulation without bite in the absence of instructions on how DCF valuation is to be arrived at and the non-existence of disclosure requirements on the methodology used for predicting cash flows and other variables. Perhaps it would be advisable then to do away with the requirement altogether. This would lend India a foreign investment friendly image and would pare down transaction costs.

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