Are changes in FCCB pricing norms a boon?

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With the gradual liberalization of exchange control regulations in India during the 1990s, Indian corporates have had the ability to raise funds from global markets. A popular instrument, especially in the past few years, has been the foreign currency convertible bond (FCCB).

FCCBs are quasi-equity instruments which enable holders to convert their bonds into equity at a later date. FCCBs became popular with issuers given their lower coupon rates which reduced debt financing costs while also affording bondholders the ability to take advantage of any price appreciation of the stock. If the prevailing market price was lower than the conversion price then the FCCB holder would not exercise their option to convert the debt into equity and would instead redeem the FCCB.

A critical component of such instruments, i.e. the conversion price, until late 2008 was based on the following pricing formula: the minimum conversion price would have to be the higher of (a) the average price of the shares of the issuing company for the six-month period preceding the relevant date; and (b) the average price of the shares of the issuing company for a period of two weeks preceding the relevant date. The relevant date for this purpose was 30 days prior to the date on which the meeting of the shareholders of the issuer company was held to consider the proposed FCCB issuance.

This pricing mechanism worked well until the demise of the Indian stock markets following the global market downturn in 2008, which consequently led to the reformulation of the pricing guidelines.

Through a press note dated 27 November 2008 the government relaxed the minimum pricing norms for the issue of FCCBs to foreign investors in alignment with the pricing norms for qualified institutional placements issued by the Securities and Exchange Board of India (SEBI). The government introduced two changes: (a) the new minimum price would be the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the two weeks preceding the relevant date (as opposed to the earlier minimum price which was the higher of the average for six months and two weeks preceding the relevant date); and (b) the relevant date for price determination would be the date on which the board of directors of the issuer decides to open the proposed issue (and not 30 days prior to the date on which the general meeting of the shareholders is held to consider the proposed issue, as it earlier stood).

These changes came after the government received feedback suggesting that the earlier pricing norms affected the corporate sector adversely in a bear or near bear market.

The changes introduced by the 2008 press note, however, had prospective effect only and did not provide the benefit of liberalized norms to FCCBs issued before 27 November 2008. This aspect invited further representations from companies and after consulting the Reserve Bank of India (RBI) and SEBI, the Ministry of Finance, through a press note dated 15 February 2010, opened a window of six months from the date of issue of the press note for companies to take advantage of the new pricing formula by revising the conversion price for FCCBs issued before the 2008 press note.

The revision of the conversion price is subject to certain conditions: (a) the issue of shares at revised pricing should not breach the shareholding limits prescribed by foreign direct investment regulations; (b) the issuing company should get approval from its board as well as from its shareholders in respect of the re-pricing; (c) the issuer company should enter into a fresh agreement with FCCB holders in terms of renegotiating the conversion price; and (d) the company must obtain prior RBI approval for such revision.

The 2010 press note, however, is ambiguous on which two-week period should be used to calculate the minimum conversion price based on the average closing share prices. There is confusion as to whether this two-week period implies the 14 days preceding the proposed date for opening the original issue, or the 14 days prior to the reset of the conversion price, which companies have now been allowed to undertake.

If a strict technical interpretation were to be taken then it is likely that the timing would refer to dates relating to the original FCCB issuance and the 2010 press note would then not provide much succour to Indian companies, since most instruments were issued during the 2007 bull-run in the stock markets. However, if the more liberal interpretation is taken then it would be useful to many companies, since it would more closely reflect current market prices, facilitate conversion to equity and ease any redemption pressure on such issuers.

It is hoped that the government will clarify this aspect as early as possible so that market participants can be comforted by the express mandate of the regulator as opposed to its implicit intentions.

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