Bond redemption: In times of credit crunch

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Liquidity woes of India Inc. seem to intensify as a recent estimate (by Edelweiss Securities) suggests that 74 companies included in the BSE 500 index had outstanding Foreign Currency Convertible Bonds (FCCBs) to a tune of US$ 10.9 billion (approximately Rupees 54,500 Crore) as on September 30, 2008. The estimate further reveals that these FCCBs shall fall due for conversion or redemption between the years 2009 and 2013. An additional US$ 3 billion (approximately Rupees 15,000 Crore) may also have to be doled out by companies on account of redemption premium payable on these outstanding FCCBs. All put together, it may appear that it would require a bond redemption, of the James Bond franchise that is, to bail out India Inc. from being mauled by these numbers.

To present a legal evolution of things, FCCBs were introduced by a scheme formulated by the Department of Economic Affairs, MoF (the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993), the purpose of which was to enable companies to raise funds abroad. FCCBs issued during the days of bull run promised high returns on redemption and good conversion rates for FCCB holders who opted to convert them to equity shares on maturity. For the company, FCCBs came at low coupon rates, lower than domestic lending rates that prevailed about a year or two back.

Though initially the FCCB route was open to both listed and unlisted companies, by an amendment to the scheme of September 5, 2005 the Reserve Bank of India (RBI) made it that only listed companies could tread this path. As the bullish market continued, the regulators also decided to constrict External Commercial Borrowings (ECBs) by companies, leaving aam companies (the unlisted ones) to the mercy of shareholders and domestic bankers.

With the volte-face by markets at the turn of this year, FCCB holders who would otherwise have picked up stake in companies decided to go ahead with exiting. Direct exit achievable only by way of redemption, companies were forced to look at refinancing options, but the roadblock here was that proceeds from fresh issue of FCCBs could not be used to pre-pay any existing facility. As a result, certain companies have in the recent past renegotiated terms with FCCB holders and reset conversion prices. This was seen as an impulsive move, as converting the outstanding FCCBs at lower rates in turn had the effect of diluting stakes of other shareholders of the Company. On occurrence of these events, anti-dilution provisions in investment agreements could come to the rescue of FIIs, mutual funds, venture capital funds and such others, but this could in turn have more than a doubling effect in diluting the stake of promoters of the company.

It was only about a couple of weeks back that RBI woke up to this issue, to announce a new credit policy that besides other things, provided for premature buyback of FCCBs. As the policy itself awaits formal nod, how this proposal would work is not clear as the Companies Act, 1956 does not throw sufficient light on buy-back of securities other than equity shares. Probably, what it means is pre-payment or redemption of the FCCBs itself. As per the policy, the

RBI has decided to consider proposals under the approval route from Indian companies to prematurely buy back FCCBs at prevailing, discounted rates. The buy-back should be financed by the company's foreign currency resources held in India or abroad and/or out of fresh ECBs raised in conformity with the current norms for ECBs. Whether the end use restrictions on FCCBs and also ECBs (which prohibit refinancing of an existing credit facility) would still apply, is not clear.

Follow up to the RBI notification, a few days ago, the MoF also effected certain amendments to the FCCB scheme. The definition of 'relevant price' used for computing the issue price has been redefined to mean the day on which the company's board of directors meet to accord its approval for issuance of FCCBs. This would in turn affect pricing of FCCBs, which shall not be less than higher of the two averages: (i) The average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date or (ii) The average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date. The change hopes to bring the issue price of FCCBs closer to prevailing share prices, thereby providing some leverage to companies intending to raise overseas investments.

As the above changes to the regulatory framework take effect, what India Inc. could possibly consider in the interim would be the renegotiation of redemption terms of FCCBs prior to maturity. Building awareness amongst FCCB holders on the Company's present credit position should give some leeway for negotiations. However, this would entail resolutions being passed at both the board and shareholders levels and obtaining other regulatory consents, which given the case that these are all listed companies, might turn out a bit cumbersome.