INDIA

Foreign investment: pricing issues

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The Government of India recently consolidated its foreign investment policy. Significant changes have also been recently introduced to the foreign investment pricing guidelines.

Foreign investment policy (the Policy)

The Policy clarifies that pricing of convertibles must be determined upfront at the time of the issue. These include mandatorily convertible preference shares and debentures which, for the purpose of the Policy, are treated as capital and not debt. This clarification appears to radically alter the practice in existence prior to the consolidation of the Policy, when convertibles were priced as equity without the need for a fixed conversion ratio. Hence, performance-linked conversion formulae that linked the number or percentage of equity shares issued on conversion to the earnings/performance of the company gained momentum to offset high promoter valuations. If the clarification is interpreted (as it is being done) to require a fixed conversion ratio at the time of issue of the convertibles, a performance-linked formula will no longer hold good. This is a little strange since a performance-linked formula appears to accord with the revised Pricing Guidelines.

Foreign investment pricing guidelines (Pricing Guidelines)

The revised Pricing Guidelines stipulate the discounted free cash flow method of valuation (DCF Method) to determine the price at which foreign investment must be made in unlisted companies, whether by way of a primary issue or a secondary transfer. The DCF Method is forward looking and discounts projected cash flows to arrive at the net present value of the company and derive the equity value. The erstwhile method was not as forward looking, and averaged net asset value with the profit earning capacity of the company. With the DCF Method, valuations are likely in certain cases to match foreign investor valuations unlike the erstwhile method, and therefore the possibility of a disparity between the regulatory valuation and the investor valuation is, to an extent, mitigated.

The disconnect between the clarification on pricing convertibles and the revised Pricing Guidelines is that the former nullifies performance linked formulae while the latter endorses estimated performance as a valid yardstick to determine the price of equity investments. Yet as both convertibles and equity are capital, shouldn't the same yardsticks apply?

A linked issue that could give rise to problems is a recent budgetary amendment to income tax laws, whereby a recipient of shares is taxed for the difference in the fair market value of shares and the consideration paid on the shares. This difference is treated as income in the hands of the recipient of shares, whether as buyer or investor. The fair market value for shares of unlisted companies is the book value. If the recipient is a foreign investor, he is bound to invest using the DCF Method. If the DCF Method gives a valuation less than the book value of the shares (in asset rich companies with low prospects, for example), the foreign investor could find itself liable to income tax even though he has invested using the DCF Method stipulation. A similar situation could arise for a resident buyer of shares who cannot under foreign investment laws pay more than a price determined under the DCF method to a foreign seller.

Finally, the Pricing Guidelines stipulated that the transfer of shares of a listed company by a resident to a non-resident must follow the preferential allotment rules on pricing as of the date of sale of shares. Hence, in respect of an open offer, if there is a price upswing between the date of the agreement to transfer shares and the date of actual transfer, the non-resident would be disadvantaged. This may not be an intended consequence.

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