Foreign Currency Convertible Bonds – Redemption and Restructuring

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Introduction

The years 2005 to 2008 saw a major bull run in the Indian stock markets. India was shining, valuations were high and there was a huge appetite in the international capital markets for paper issued by Indian companies. Arguably, one of the most popular instruments employed by Indian companies to raise funds in this period was the foreign currency convertible bond ("**FCCB**"). An FCCB is essentially a foreign currency denominated debt security that carries a fixed coupon and / or redemption premium, and also has an option of being converted into the shares of the issuer company based on a fixed conversion price and exchange rate. This hybrid mix of debt and equity attached to an FCCB made it an attractive proposition for Indian companies.

An FCCB was viewed as a 'win-win' proposition by investors and issuer companies alike. Investors saw an FCCB as providing downside protection with unlimited upside benefits, while issuer companies took the view that an FCCB would, over its life span, almost always get converted due to the continuous upswing (at that stage) in the Indian stock markets. However, the global recession that set in subsequently, coupled with an inefficient legal redressal system has resulted in an FCCB becoming a double edged sword. From the investor's point of view, since the majority of the issuer companies' current stock prices are well below the conversion price of the FCCBs fixed at the time of their issuance, there is no question of any upside arising from converting the FCCBs. Most investors are also not in favor of long drawn legal proceedings before Indian courts to recover their money. From the perspective of the issuer companies, if the FCCBs are not redeemed upon maturity, these could result in being classified as debts due, which could open such companies up to potential winding up actions, amongst other legal actions. Failure to redeem the FCCBs on maturity would also have an adverse reputational impact on issuer companies and their promoters, which would make returning to the international capital markets in the future a difficult proposition.

Reasons for financial distress being faced by Indian companies

Some important reasons for the financial distress being faced by Indian companies vis-à-vis FCCBs are set out below.

1) *Global downturn*

The slowdown that is being witnessed in the global economy has had its repercussions in India as well. The demand for goods and services being offered by Indian companies has dropped, with consequent knock-on effects on the financial results of these companies. The crisis in Europe has further aggravated this situation.

2) *Crashing stock markets*

Most issuer companies had set the conversion prices of their FCCBs at a significant premium to the stock prices prevailing at the time of the issuance of the FCCBs, assuming that the stock prices would continue to rise. The global financial crisis was the first step towards correction of the Indian markets. The subsequent fall in stock prices has further widened the gap between the conversion price of those FCCBs, and the current market price of the relevant stocks. As a result, it is extremely unlikely that these FCCBs would be converted into the equity shares of the issuer companies, as originally envisaged by the issuer companies.

3) *Rupee devaluation*

During the period between 2005 and 2008, the Indian economy was growing at the rate of approximately 9%, the Indian rupee was going strong and experiencing record highs against the dollar. During this period, the Indian stock markets echoed this sentiment which was reflected in the pricing and conversion calculations of FCCBs. At present, thanks to the heavy spending by government on subsidies, swollen current account and general negative perception in the International markets about the country, the rupee has hit record lows. The devaluation of the rupee would in effect mean that unless an issuer company has a natural hedge by virtue of its business operation, the dollar pay out on an FCCB redemption would be more expensive. Looking at it practically, the devaluation of the rupee could not have happened at a time worse than the present.

4) *Policy paralysis*

Much has been said and discussed at various forums about the policy paralysis faced by India. India is facing a turbulent time where questions have been raised by the global investor community on issues such as regressive regulatory and tax developments and perceived levels of corruption. A time consuming and costly enforcement mechanism has not helped India's

case either. All these factors taken together could also be a reason for holders of FCCBs being less flexible in accommodating an issuer company facing redemption pressures.

The year 2007 saw large amounts being raised by Indian companies through FCCB issuances with a vast majority of such FCCBs having a maturity period of 5 years. As a result, those FCCBs that have not been converted so far are due to be redeemed in 2012. As per a recent report published by Fitch Ratings, a total of 59 Indian companies are facing redemption of FCCBs for an aggregate amount of US$ 7 billion in 2012.

Restructuring options available to India Inc.

Indian companies having issued FCCBs that are due for redemption have the following options:

Refinancing

One of the options available to an issuer company is to consider raising fresh debt. The Reserve Bank of India ("**RBI**") has permitted issuer companies to avail of fresh external commercial borrowings ("**ECBs**") or FCCBs to finance the redemption of existing FCCBs under certain conditions. Practically speaking however, raising fresh debt through ECBs or FCCBs may not be a solution in the real sense. Adoption of this mode would result in a higher interest outgo. The falling Rupee against the dollar has even made this option more expensive and therefore economically less viable for an issuer company which is already reeling under the pressure of redemption of FCCBs.

Equity offerings

FCCB issuers could consider raising additional funds through issuances of equity to repay the FCCB holders. A hospitality giant in India, which until sometime back was under a significant debt burden, undertook a qualified institutional placement ('**QIP**'). From publicly available information, the proceeds of the QIP were proposed to be used for debt reduction and redemption. Having said that, realistically, in today's day and age, an equity offering may not be a viable option - volatile Indian stock markets have resulted in (i) unattractive valuations for promoters, and (ii) a high level of deal uncertainty due to waning investor demand.

Buyback of FCCBs

Under this route the issuer company may consider buying back the FCCBs from FCCB holders. In terms of the extant regulatory regime, the RBI permits an issuer company to buyback its FCCBs (i) from existing foreign currency funds and/or fresh ECB proceeds at a minimum discount of 8 per cent. to their book value and (ii) from internal accruals with RBI approval at a minimum discount ranging from 10 per cent. to 20 per cent. to their book value. However, given that FCCBs typically trade in the international markets at their accreted value (which is normally at a significant premium to their book value), these discount levels are not always conducive to successful transactions.

However, the above options may not be feasible for most of the issuers with FCCBs due for redemption in 2012, due to lenders being unwilling to extend credit to them, paucity of cash flows, reduced valuations of their assets and volatile equity markets. The only option left to such issuers would be to explore options for restructuring of their FCCBs, which is dealt with in detail below.

Restructuring of FCCBs

What does restructuring of FCCBs entail?

The term 'restructuring' of FCCBs is typically used in a generic sense, for a mechanism pursuant to which the holders of the FCCBs agree to either modify the terms of the existing FCCBs or substitute the existing FCCBs with new FCCBs, which results in an instrument with revised terms which are mutually acceptable to the issuer as well as the FCCB holders. The typical features of the new instrument could include:

1) A reduction in the conversion price to a level commensurate with the current stock prices – this would encourage conversion of the FCCBs, resulting in elimination or reduction of eventual redemption pressure;
2) An extension of maturity of the FCCB – this would provide more time to the issuer to turn its business around and either generate enough cash flows to eventually redeem the FCCBs on maturity, or have its stock price increase to a level where conversions are possible;
3) Introduction of a cash coupon – the majority of the FCCBs issued in the 2005 – 2008 period were zero coupon FCCBs, with all the interest to be paid out on redemption. Since these would not be redeemed, their holders would be in a position where they would not have received any income on such FCCBs for the past five years. FCCB holders are therefore keen to ensure a regular income on their investment going forward;
4) Introduction of financial covenants – FCCB holders could require financial covenants to be undertaken by the issuer (e.g., debt to equity ratios or debt to EBITDA ratios) in order to provide them with 'early warning' signs that the issuer may not be in a position to redeem even the new FCCBs on their maturity; and
5) Provision of security – in certain cases, FCCB holders could also require as a pre-condition to the restructuring, that the issuer provide some level of security to secure the redemption of the new FCCBs.

Restructurings of FCCBs can take place through different modes. The most common ones that have been used by Indian companies till date are (i) exchange offers pursuant to which the existing FCCBs are exchanged on a cashless basis for new FCCBs with revised terms, and (ii) modification of the terms of the existing FCCBs. The

notable difference between the two from a regulatory standpoint stems from an RBI regulation that restructuring of FCCBs resulting in lowering their conversion price is not permitted. Therefore, in an exchange offer (where a new FCCB is issued), this can be achieved as a new instrument is being issued, with the conversion price being fixed anew. However, where only the terms of the existing FCCBs are being modified, this would not be possible.

Typical issues surrounding FCCB restructurings

The first issue that an issuer seeking to restructure its FCCBs has to grapple with is that the holders of the FCCBs are normally spread across the globe. Further, since FCCBs are typically traded through the Euroclear / Clearstream systems, the holders of the FCCBs are not easily identifiable. The issuer would therefore typically appoint an adviser who is well versed in the restructuring process and then make an announcement through the clearing systems to the effect that it is contemplating a restructuring, and that any interested FCCB holders could contact its adviser for further details.

The terms of the FCCBs would typically provide for thresholds of consent that would be required from FCCB holders to undertake certain actions in relation to the FCCBs. Once the relevant number of FCCB holders has been identified, the issuer and its adviser would have to negotiate the terms of the new instrument with these holders. If the existing FCCBs are already in default, it is also possible that the FCCB holders could initiate legal proceedings against the issuer in order to make their intentions clear.

Once the issuer has an idea of a set of revised terms that would be acceptable to the FCCB holders, the next step would be to call for a meeting of the FCCB holders where its proposal can be considered (and approved, if possible) by the FCCB holders.

The other process that is critical in the context of an FCCB restructuring is the requirement for approval of the RBI for the restructuring before the restructuring can be concluded. Very often, this can give rise to a 'chicken and egg' situation, where in order to approach the RBI, details of the restructuring package are required, but finalization of the package itself requires RBI approval in the first place. This requires a very fine balancing act of reaching a stage where there is relative certainty as to what terms would be acceptable to the FCCB holders and applying to the RBI at that stage, even if the meeting of the FCCB holders has not taken place yet. In an ideal scenario, the same terms would be approved by the RBI as well as the FCCB holders. If there are any discrepancies between the two, the settlement of the restructuring would have to be delayed until such time as they can be resolved, either by re-approaching the RBI, or the FCCB holders. Thankfully though, the experience so far seems to suggest that issuers do manage to eventually resolve this problem.

Conclusion

By far, the most important fact that an issuer should be aware of is that restructurings are a time consuming process. Therefore, unless an issuer is confident of redeeming its FCCBs at maturity through one of the modes set out above, it should commence its restructuring efforts at the earliest, before it defaults on the redemption of the existing FCCBs. Experience has shown that the earlier such efforts are commenced, the better the negotiating position of the issuer. FCCB holders also normally view 'late in the day' restructuring efforts with a degree of skepticism, leading to doubts arising in their minds as to the *bona fide* nature of such efforts.

On a broader note, the global investor community is keeping a close watch on the current situation in India and especially on the way the issue surrounding FCCB defaults is handled, both at the Governmental level as well as at the level of India Inc. The credibility of Indian issuers is at stake and therefore, it may be an opportune moment for the regulators to intervene and make suitable changes to the regulations which not only aim at improving the current situation but also going forward, provide adequate safeguards to the global investor community so as to increase their confidence. Examples of such changes could be requiring issuers to mandatorily create an FCCB redemption reserve by setting aside money from its profits and / or capping the exposure of companies to such instruments. In any event, it is critical that suitable steps are taken to renew the image of Indian issuers in the international markets, in order to pave the way for a return to the earlier years of "India shining".