Foreign Currency Convertible Bonds - The Road Ahead

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Background:

Following policy liberalization by the Government of India in 2005, Foreign Currency Convertible Bonds ("FCCBs") gained popularity among Indian companies for raising capital at attractive terms by tapping into the deep pool of international institutional investors. The Indian FCCB market took a significant leap during the equity market bull-run from 2005 – 2007 with Indian corporate raising over US$17bn from 150+ transactions during the period.

FCCBs are generally U.S. dollar-denominated bonds, with a fixed maturity of at least 5 years, and carry a very low interest rate owing to the value of the embedded equity option. The embedded equity option gives investors the choice to convert the FCCBs into equity shares at a predetermined price, generally at a premium to the price at the time of the issuance.

This strategy helped issuers achieve low-cost foreign currency funding for overseas acquisitions or business expansion and also helped in reducing borrowing costs. A significant majority of the FCCBs issued in 2005 – 2007 came with very low coupon rates. Many of these FCCBs came with a zero coupon, and a back ended yield with average conversion premium over 30%. Issuers and investors expected India's stock market to continue to rise and the price of the companies' stock to exceed the conversion price when the FCCBs matured. At that point, bondholders could have converted their holdings to equity and the issuers would not have had to redeem the bonds for cash. This theory fell flat with the subsequent crash in global equity markets from 2008 onwards, leading to steep decline in stock prices and depreciation in the INR.

Fallout of global financial crisis:

A large portion of the FCCBs were sold before the global financial crisis, when there was significant foreign investor demand for Indian paper, the rupee was perceived to be stable and strong and the stock market was in a secular bull run. With stock prices having plummeted, the equity option strikes (at a high conversion premium) turned out to be heavily out-of-the-money. At the same time investor interest waned and most of these investors were keen to get their cash back by redeeming the FCCBs at maturity.

Redemption of the FCCBs turned out to be challenging for most FCCB issuers because they had limited access to new funds and borrowing rates were high. Further, most of the issuers had not planned for a redemption scenario and thus did not have enough cash on hand to repay the FCCBs; to make matters worse, the broader volatility in the markets made refinancing alternatives very challenging to execute for most of these issuers. Further, the weaker rupee along with the back ended yield resulted in the amount of cash required to redeem the bonds much larger than envisioned earlier.

To put things in perspective, of the US$8.3bn raised by Indian issuers in 2007, c.US$6bn was raised at an exchange rate of less than 41. Most of these were due in 2012 by which time the rupee had depreciated over 30%, adding c.US$2bn to the value of the FCCB maturities and putting further pressure on already stretched balance sheets.

Policy response:

Envisaging the difficulties that Indian companies may face in arranging funds for redemption of the FCCBs, in July 2011 the RBI relaxed ECB/FCCB guidelines to facilitate refinancing of existing FCCBs. Some of the key measures included raising fresh ECBs/FCCBs under automatic route subject to certain conditions, restructuring and buy back of FCCBs. Regulators also allowed companies to reset conversion prices to facilitate conversion in some select cases. While these measures were a step in the right direction, they came with certain restrictions which meant that a majority of the issuers could not leverage these policy changes to manage their redemptions.

Defaults and restructurings:

As the global economic crisis continued to spread, it slowed the revenue and profit growth of Indian companies and dragged down their stock prices. With corporate balance sheets already stretched, and lack of new funding avenues, a number of FCCB issuers were unable to service their debts on time, resulting in default. While some companies defaulted, others were more prudent in negotiating with their FCCB investors to restructure the debt

ahead of time and prevent the stigma and associated complexities of entering a technical default. A number of issuers are still embroiled in complex and lengthy negotiations and legal battles with their FCCB investors to find a way out of an FCCB default

An unintended effect of recent legal cases by FCCB holders seeking liquidation of bond issuers (upon a default) is that it may weaken the credibility of Indian FCCBs. Recovery expectations of FCCB holders may take a hit if secured lenders to the company also consider recovery actions for defaults on secured loans.

Way forward:

Nevertheless, despite some drawbacks, the benefits of an FCCB issuance tips the balance in favor of FCCBs. Indian issuers have relied on FCCBs as a major financing tool for capital expenditure requirements at competitive rates, raising over US$25bn in the last decade. A key point to note is the number of companies defaulting on the outstanding FCCBs is limited and majority of the FCCBS, especially those issued by large blue chip issuers, have been successfully redeemed. In certain cases, outstanding FCCBs were restructured into equity or were rolled over to bonds with higher coupon and maturity at later dates. Press coverage and certain investor actions amplified the negative perception around the product and do not factor in the successful restructurings that investors participated in.

FCCBs issued during the previous bull-run were structured on terms favoring the issuer with zero coupon, hefty redemption premium and a significant conversion premium to the prevailing market price. Some trends observed in recent FCCBs indicate more balanced terms with higher coupon rate, minimal redemption premium and lower conversion premium on average. While select issuers can still access FCCB financing at the right terms, the broader investor community still maintains a cautious stance towards Indian mid cap and small cap names. Changing this perception will require management and promoters of Indian companies to demonstrate a lot more prudence and strategic planning in managing their businesses, balance sheets and cash flow going forward. For instance, issuers could consider accruing cash in ringfenced accounts to provide investors with comfort on future sources of refinancing.

A further relaxation of applicable guidelines and policies governing FCCB issuance would also help in increasing the popularity of the FCCB as a viable capital raising alternative. In particular, it would allow issuers to obtain cheaper and more effective source of financing, as well as appeal to the international investor community. A few areas where policy changes can meaningfully address investor and issuer concern include (i) allowing issuers to raise FCCBs with less than 5 year maturity to bring it in line with the rest of the Asian market where the most common tenor for CBs is 3 years (ii) remove or increasing the coupon ceiling of L+500bps to give more flexibility to issuers to raise financing.

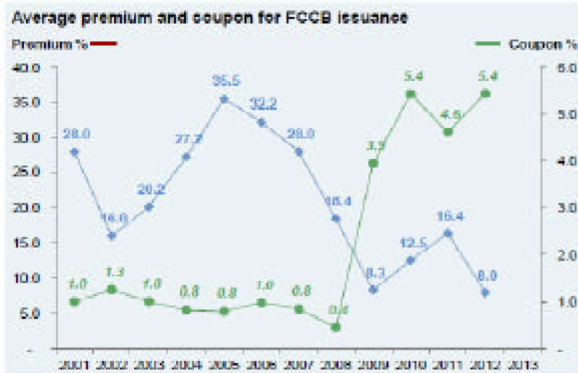
In the current rising interest rate environment, issuers may want to evaluate FCCB issuance to manage borrowing costs and meet their capital requirements. Given high amount of FCCB maturities in 2012, convertible bond investors are currently sitting on a large cash pile and hungry for new paper. However, given past experiences, both investors and issuers are likely to be cautious in their approach.

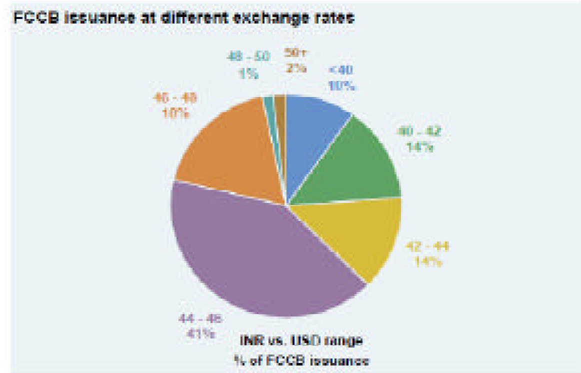
Exhibit 1.1

Source: Bloomberg, Dealogic

Exhibit 1.2

India FCCB issuance since 2001





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