ALLEN & OVERY

India in focus

Pricing considerations for foreign direct investment in India

1. Overview

As we explored in the last India in Focus **article**, the legal framework governing foreign investments in India is derived from an interconnected bundle of legislation, regulations and policy documents which together are commonly referred to as the Indian Exchange Control Regulations. These prescribe mandatory pricing guidelines for foreign investment in India.

In this article, we focus on the pricing guidelines applicable to foreign direct investment (**FDI**) – the only investment route which does not require prior investor registration with the Securities and Exchange Board of India (**SEBI**), the statutory authority responsible for regulating India's capital and securities markets. However, investors should also note that separate pricing guidelines apply for foreign portfolio investment and foreign venture capital investment in India. The pricing guidelines are wide in scope and merit careful consideration when considering any inbound investment or investment exit in India.

2. Price considerations for foreign investors

FDI is the regime that largely governs longer term foreign investment into the equity of Indian unlisted (private) companies or listed companies. FDI is limited to investments through equity instruments such as shares, fully and mandatorily convertible debentures or preference shares and share warrants. The purchase or sale of such equity instruments by a foreign investor is subject to price caps and/or ceilings anchored to the central principle that a foreign investor should not benefit from a more advantageous pricing structure than that which is considered *fair market value*.

The pricing guidelines apply on a wide range of transactions including those outlined below.

In this article, the term "foreign investor" refers both to an individual investor that is non-resident in India and also to an Indian company that is owned and / or controlled by persons residing outside of India.

Issuance of Equity Instruments to Foreign Investors – Price Floor

Foreign investors may only subscribe for equity instruments in an Indian unlisted company at a price which is not less than the fair value of those equity instruments, as calculated in accordance with any internationally recognised valuation methodology on an arms' length basis, and certified by a chartered accountant or SEBI registered merchant banker.

For issuances of equity instruments in an Indian listed company, a similar price floor applies. Such issuances to a foreign investor must not be less than the fair market value price calculated pursuant to the relevant SEBI guidelines.

Transfer of Equity Instruments to Foreign Investors – Price Floor

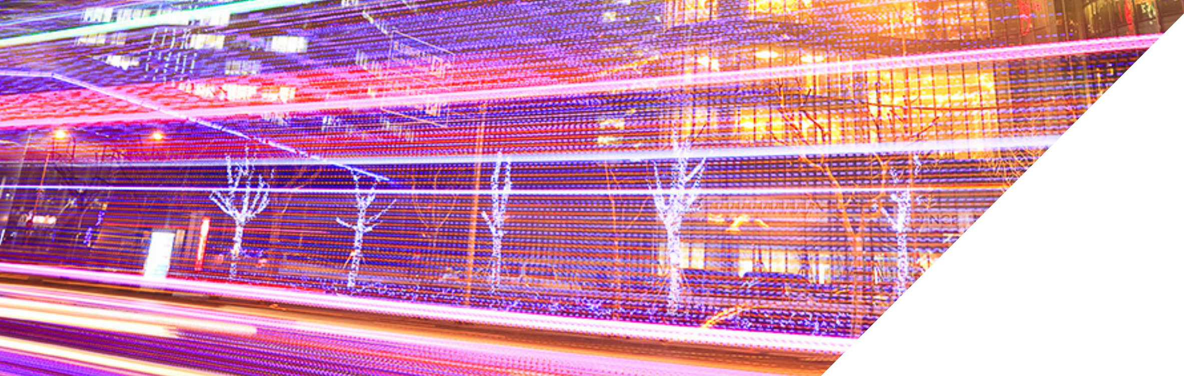
A transfer of equity instruments from an Indian resident (either an individual or corporate entity) to a foreign investor follows the same price floor guidelines as set out above for primary issuances.

Transfer of Equity Instruments from Foreign Investors to Indian Residents – Price Ceiling

Logically, the opposite applies for transfers made from a foreign investor to an Indian resident. In these circumstances, the price of the equity instruments must not be greater than the fair value of those equity instruments. As above, for Indian unlisted companies, this value is based on an internationally recognised pricing methodology and for Indian listed companies, in accordance with the relevant SEBI guidelines.

The effect of these pricing guidelines is to create price risk for a foreign investor looking to acquire equity instruments in an Indian company. Any such investment is made on the basis of *no guaranteed returns* should that foreign investor look to later sell or transfer such equity instruments to an Indian resident company or individual. In these circumstances, a foreign investor must sell or transfer their instruments at the prevailing fair market price at the time of the sale or transfer.

However, sales or transfers of equity instruments in an Indian company from one foreign investor to another are not caught by these pricing restrictions. This provides one mechanism for foreign investors to realised potentially uncapped returns on their investments in India.



3. Put options and their limitations

Since early 2014, foreign investors have been able to purchase equity instruments in Indian companies with so-called “optionality clauses” (otherwise known as put options). This relaxation was designed to increase FDI into India by providing foreign investors with the option to build obligatory buy-back provisions into the relevant equity instrument documentation.

However, a note of caution. In the context of FDI, foreign investor access to equity instruments with such optionality clauses remains subject to specific restrictions.

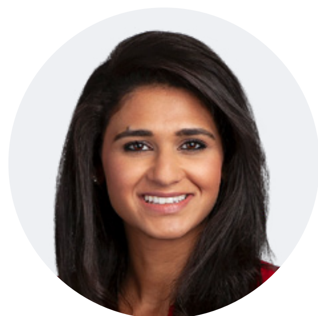
Most significantly, a foreign investor is subject to a minimum lock-in period of at least one year following the date of purchase and cannot request that the equity instruments are bought back at a guaranteed price. The put option must be exercised at the prevailing market value determined at the time of exercise, and only following the lock-in period.

4. Commentary

A review of the pricing guidelines, and their applicability, should be a priority when considering any foreign investment in India. These guidelines apply both on the purchase or subscription of equity instruments in Indian companies by foreign investors and any secondary sale or transfer of such instruments held by foreign investors to Indian residents.

Of particular note, the pricing guidelines capture secondary disposals to individuals that are resident in India and also to Indian companies owned and / or controlled by persons resident in India. This may have implications for equity ownership further up the transaction structure so early due diligence is essential.

5. Key contacts



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