Introduction

CCPSs – (Compulsory Convertible Preference Shares) are increasingly becoming preferred investment instrument for high net worth and PE investors to bridge the gap in mismatch in valuation expectation between investors and promoters. The CCPS are anti dilution instrument or hybrid instrument. Let us discuss in detail the characteristics of CCPSs.

Anti Dilution

CCPS benefited to the promoters of the company to keep their equity stake intake when Company issue equity shares to new investor. The Promoters may convert their CCPS which was taken at the time of Lower valuation of shares when new investor bring the money at higher valuation thereby promoters can increase its stake without bringing money at higher valuation.

Benefited to PE investors

CCPS are also benefited to PE Investors. The investors may link the time of conversion to Company's performance. This essentially means that the shares get converted only after the company achieves the promised growth. If the milestones are not achieved, then the PE firm reserves its right to increase the stake.

Secondly Under the capital market regulator's norms, any acquisition of 15% or more in a listed company triggers an open offer. Accordingly a PE firm can take 14.9% direct equity and the rest in the form of securities that turn into equity within 18 months. This gives the firm the leeway to exit its investment in parts as typically a PE investment has a one-year lock-in period. In other words, before owning more equity and exceeding the 15% threshold limit, a PE firm can cash out at least a part of its existing stake, and avoid making the mandatory open offer.

Benefited to start-ups

The CCPS helps to the start-up Companies founders to control their stake at the funding stage of new investors without infusion of new funds. CCPS are also anti dilution securities and founders can manage their equity stake to keep control in the Company by holding substantial stake in the Company.

Avoid Valuation Gap

The CCPSs helps to avoid valuation gap between founder and Investors. In theory, there are many methods to come up with per share value of equity.

In the secondary market, the most popular method is what is called 'relative valuation'. Here, one uses multiples such as price-earnings, or EV/EBITDA, or price-to-sales (P/S) or price-to-book to arrive at a valuation. Here, you take a number like P/E from a set of comparables, and apply that to the company you want to value.

This is not easy to apply to start-ups because a typical start-up may have no profit and loss (P&L) metric to show.

In other words, let alone net profit or EBITDA, it could be pre-revenue. Or even if the business is launched, it would be just one or two years old. Revenue may not be enough to even apply a price-to-sales (P/S) multiple.

The other popular valuation method is the so-called discounted cash flow or DCF method. The problem with this method is, there are too many assumptions involved. You need to do at least five years of forecast, and use assumptions to arrive at the applicable cost of capital and terminal value. Other than in certain predictable businesses like utilities, in other cases, using DCF is no better than witchcraft. This brings us to what actually happens in the real world.

Therefore one simple way to totally avoid a valuation discussion, particularly if there is strong difference of opinion with the promoter, is to invest via convertible preference shares wherein the angel's price is determined once the Series A investor (venture capital, who chips in as first-time investor) comes in. You can convert to common shares at a discount to Series A. This method will typically need a cap and floor on valuations though.

Regulatory Framework for issue of CCPS.

The issue of CCPS securities is a strategic decision of the company and play a very important role while controlling the equity stake of the founders or promoters of the Company. Slight irregularity can impact substantially in the Holding structure of Founders. Further issue of CCPS involved compliance of three major laws.

a) Companies Act, 2013
b) Foreign Exchange Management Act, 1999
c) Income Tax Act, 1961

Companies Act, 2013

The Issue of CCPS are primarily governed by provisions of Section 42, 62 and 55 of Companies Act, 2013 read with Companies (Prospectus and Allotment of Securities) Rules, 2014 and Companies (Share Capital and Debentures) Rules, 2014

FEMA Regulatory Framework

The CCPS are equity linked instrument hence Foreign Investors may subscribed under the Foreign Direct Investment Policy under automatic route subject to sartorial cap and Pricing Guidelines. Under the said policy the conversion terms and conditions shall be determine upfront at the time of issue of said instruments. The Price at the time of conversion should not in any case be lower than the Fair value worked out at the time of issuance of such instruments. The Conversion working is workout in the illustrative form as under.

No. Of CCPS	Fair Value at the time of Issuance of of CCPS	Issue Price	Fair Value at the time of Conversion of CCPS into Equity	Conversion Price	FDI compliance
X	20	30	50	20	Complied
X	20	30	10	10	Not Complied

It is pertained to note that, Indian Company cannot issue Non Convertible Preference shares under the FDI policy. The same is governed by External Commercial Borrowing Regulations. Further Indian Company may issue optionally convertible Preference Shares subject to restrictive conditions of minimum Lock-in period and restriction of assured returns to Foreign Investors. Therefore one must take prudent decision while selecting the convertibility aspect of Preference Shares.

Further treatment of post compliance of issue of CCPS such as filing of Advance reporting form, FYC, FIRC and FCGPR are same at the time of issuance of Equity Shares. Now question has been arises whether Company need to file FCGPR Again at the time of Conversion of CCPS into Equity Shares. The FDI policy does not mentioned regarding filing of FCGPR at the time of conversion of CCPS into Equity Shares. However as a matter of abandoned caution it is always better to inform the RBI regarding details of conversion of CCPS into Equity shares, so that RBI will update their records relating to Foreign Equity Holding.

Taxation Regulatory Framework

The valuation of CCPS shall be subject to provisions of Section 56 (2)(viib) of the Income Tax Act, 1961 which states that where a unlisted company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares shall be chargeable to income-tax under the head Income from other sources. However aforesaid pricing restriction is not applicable when shares are issued to non resident person.

Stamp duty Aspect of CCPS.

The treatment of Payment of stamp duty on CCPS Certificate shall be governed by relevant state Stamp Duty Act. However question arises whether Stamp duty again required to be paid on issuance of Equity share Certificate post conversion. In my view no stamp duty is required to be paid on Equity Share Certificate as it will not change its Category.

International practice for issue of CCPS:

USA

In USA, Preference shares are known as preferred Stock and Equity shares as Common Stocks. In the United States there are two types of preferred stocks *straight* preferred and *convertible* preferreds. Straight preferred are issued in perpetuity (although some are subject to call by the issuer, under certain conditions) and pay a stipulated rate of interest to the holder. Convertible preferreds—in addition to the foregoing features of a straight preferred—contain a provision by which the holder may convert the preferred into the common stock of the company (or, sometimes, into the common stock of an affiliated company) under certain conditions (among which may be the specification of a future date when conversion may begin, a certain number of common shares per preferred share or a certain price per share for the common stock). In fact, in US it is a common practice to value the common shares and other preference shares issued by company including startups for complying with tax regulations. These valuations in US are commonly referred to as 409A valuations and are carried out using advanced models using option pricing methodologies. The empirical data derived from the 409A valuations indicates that the value of common shares is at a significant discount ranging from 30-60% to the preference share value.

UK

Perpetual non-cumulative preference shares may be included as Tier 1 capital. Perpetual cumulative preferred shares are Upper Tier 2 capital. Dated preferred shares (normally having an original maturity of at least five years) may be included in Lower Tier 2 capital.

Germany

Preferred stock may comprise up to half of total equity. It is convertible into common stock, but its conversion requires approval by a majority vote at the stockholders' meeting. If the vote passes, German law requires consensus with preferred stockholders to convert their stock (which is usually encouraged by offering a one-time premium to preferred stockholders). The firm's intention to do so may arise from its financial policy (i.e. its ranking in a specific index). Industry stock indices usually do not consider preferred stock in determining the daily trading volume of a company's stock; for example, they do not qualify the company for a listing due to a low trading volume in common stocks.

Conclusion:

In view of the above discussion, various legal compliances are involved to make the CCPSs live. However, now a days, CCPSs are playing a very important role in the strategic decision of the Company, Investors and Founders.