Indian Depository Receipts: Pros & Cons

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With the advent of the IDR, the stage is now set for companies incorporated outside the country to access the Indian capital markets. After much delib-eration, the script has been penned - whether there are any takers remains to be seen.

The Department of Company Affairs (DCA) has notified the Companies (Issue of Indian Depository Receipts) Rules, 2004 (the IDR Rules) four years after the insertion of section 605-A in the Indian Companies Act permitting foreign companies to make a public offer of Indian Depository Receipts (IDRs). The rules pave the way for the foreign companies to raise funds in India by issuing depository receipts against their underlying equity shares. This will provide an opportunity to Indian investors to share wealth of foreign companies in a manner similar to Indian companies share their wealth with overseas public investors through ADR and GDR issues. These rules are expected to take Indian markets closer to being totally global.

The story of the IDR is not a recent one - the concept of IDRs was earlier introduced by DCA in the Companies Bill 1997 but could not find a place in the actual amendments introduced in the Companies Act 1956, in 1999. The provision enabling the issue of IDRs was introduced in the Companies Act by the Companies (Amendment) Act, 2000 which gave power to the Central Government to make Rules for the offer of IDRs and related matters. The DCA subsequently issued a draft of the IDR Rules in 2002 and invited comments from certain regulatory / professional bodies. The recently issued IDR Rules are the outcome of this whole process.

An IDR can be understood as a mirror image of the familiar ADRs / GDRs. In an IDR, foreign companies issue shares to an Indian Depository, which would, in turn, issue Depository Receipts to investors in India. The Depository Receipts would be listed on the Stock Eexchanges in India and would be freely transferable. The actual shares underlying the IDRs would be held by an Overseas Custodian, which will authorise the Indian Depository to issue the IDRs. The Overseas Custodian is required to be a foreign bank having a place of business in India and requires approval from the Finance Ministry for acting as a custodian while the Indian Depository needs to be registered with SEBI.

An IDR issue requires approvals from the Ministry of Finance (MoF), SEBI and from local securities authorities. It needs to be approved by SEBI, and an application in this regard has to be made a minimum of 90 days before the issue-opening date. The overseas company also has to file a due diligence report and a Prospectus or Letter of Offer with SEBI and the ROC.

In addition, the overseas company will have to obtain in-principle permission for listing on stock exchanges in India. Moreover, the issuing company has to list on one or more stock exchanges having nationwide trading terminals.

The overseas company undertaking the IDR issue needs to have a pre-issue paid-up capital and free reserves of at least $100 million and an average turnover of $500 million during the last three financial years. At present product companies are mostly looking at more developed markets for better valuation, while software or outsourcing service companies are looking at raising funds from countries like India.

Overseas companies also need to have earned profits in at least five years preceding the issue and should have declared dividends of at least 10 per cent each year during this period. Further, the pre-issue debt-equity ratio of such company should not be more than 2:1. The criteria for the declaration of dividends may pose a problem for foreign companies. For example, in the US, it is not common for companies to declare dividends; all the profits of a company are typically re-invested into the business of the company. It might have been better to prescribe criteria of distributable profits as laid out in the SEBI (Disclosure and Investor Protection) Guidelines, 2000.

It is interesting to note that while Indian unlisted companies coming out with an IPO also need to comply with certain criteria relating to net worth and profitability, there is no criterion relating to the dividend distribution track record and debt-equity ratio.

The present IDR Rules do not require the overseas company to have a place of business in India. It is a moot point whether there should be a Representative Office or a process server mechanism to make the proposal acceptable to Indian law. At present, it is also not mandatory for the issuing company to be listed overseas. However, the company would have to agree to publish its quarterly audited financial results in Indian newspapers.

Some of the other conditions prescribed under the IDR Rules are that the issue of IDRs during any financial year should not exceed 15 per cent of the paid-up capital plus free reserves of the issuing company; and that the IDRs would not be redeemable into underlying equity shares before one year from the date of issue of IDRs. The IDRs would be denominated in Indian rupees, irrespective of the denomination of the underlying shares.

Any person resident in India as defined under the Foreign Exchange Management Act, 1999; which includes any person or body corporate registered or incorporated in India, can purchase IDRs. This could mean that apart from individuals and companies, even foreign institutional investors (FIIs) should be eligible to purchase IDRs. However, foreign venture capital investors (FVCIs) and venture capital funds (VCFs) would not be eligible to invest, as the current regulations governing them permit them to invest only in IPOs of certain domestic companies.

Indian investors also need to consider the tax implications of investment in IDRs / underlying equity shares. The domestic depository will distribute dividends declared by the issuer to the IDR holders. As foreign dividends are fully taxable, the IDR holders would have to pay tax on the dividends received by foreign companies on such IDRs. If the tax on dividends has been withheld in the issuer's country, the IDR holders will have to be given tax credit for the same in India.

IDRs will open up new avenues for foreign companies wanting to acquire or take over Indian companies. This will facilitate stock-swap transactions where Indian promoters have to be offered stock in foreign companies in excess of the current limit of $25,000. The rules do not stipulate anything about the voting rights of the IDR holders. The accounts of the issuing company will have to be recast according to Sebi's guidelines or the listing agreement, so that it is in tune with Indian accounting practices and easier for investors to understand.

The IDR route is attractive for small and mid-cap foreign companies, which are familiar with Indian markets or have promoters of Indian origin. Typically, these companies would be based in the US and SE Asia.

With the cost of compliance increasing for companies that want to be listed in the US and other markets, listing in India may be an attractive option for foreign companies that view India as a potential market.