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UNIVERSITY OF NOTTINGHAM



**Identification of opportunities from FCCBs
for Kotak Mahindra Asset Reconstruction
Department (ARD)**

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MBA FINANCE

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A Dissertation presented in part consideration for the degree of MBA in Financial Studies.

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Abstract

Foreign Currency Convertible Debentures (FCCBs) have, in last 4 years, become a major and a cheaper source of finance for Indian companies. Till very recently FCCBs acquired accolades of being a flexible instrument, giving the holder the right to convert the bonds into equity and providing funds to the issuing company at negligible rate of interest. However, the sub-prime crisis in US led the financial institutional investors (FIIs) to pull-out from Indian Markets causing the Stock Market crash in India. This has resulted in a huge possibility of non-conversion of FCCBs and thus, the redemption pressure on Indian Companies. The paper deals with the opportunities arising for Kotak Asset Reconstruction Department (ARD) from such a situation.

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Introduction

Over last few years Indian Companies have been issuing Foreign Currency Convertible Bonds (FCCBs) as a source of finance. Asset Reconstruction Department of Kotak Mahindra Bank, which is in search of new business model, is of the opinion that these FCCBs might be a source of revenue to their department in some or the other form. The paper, thus, researches to identify various revenue opportunities for Kotak ARD from these FCCBs.

The paper is divided into five sections. In the first section the paper initially starts with an introduction about the Kotak Mahindra Group and its group companies and then continues with a brief description about the working of various sub-divisions in Kotak ARD so as to better identify the business opportunities from the task at hand. A brief literature review on FCCBs then follows in the second section to get a clear understanding of the nature of the instrument. Third section involves brainstorming and analysis of various revenue options available for Kotak Single Assets Group (SAG), from FCCBs, with the conclusion that FCCBs might offer better opportunities for Kotak Advisory Group than Kotak SAG. Fourth section involves actual identification process under the option selected in section four. Here, 14 companies that are listed on Bombay Stock Exchange and have issued FCCBs are analyzed followed by conclusion and recommendation for each company. Fifth and final section gives the gist of entire analysis with the final conclusion that FCCBs provide excellent revenue earning opportunity for Kotak Advisory and some opportunities for Kotak SAG as well.

Section 1

About Kotak Mahindra Group:

Kotak Mahindra is one of India's leading financial conglomerates, offering complete financial solutions that encompass every sphere of life. From commercial banking, to stock broking, to mutual funds, to life insurance, to investment banking, the group caters to the financial needs of individuals and corporate. (http://www.kotak.com/Kotak_GroupSite/aboutus/default.htm)

The Kotak Mahindra Group was born in 1985 as Kotak Capital Management Finance Limited. This company was promoted by Uday Kotak, Sidney A. A. Pinto and Kotak & Company. Industrialists Harish Mahindra and Anand Mahindra took a stake in 1986, and that's when the company changed its name to Kotak Mahindra Finance Limited (http://www.kotak.com/Kotak_GroupSite/aboutus/our_story.htm).

Following time-line gives the idea of journey of success of the group (http://www.kotak.com/Kotak_GroupSite/aboutus/our_story.htm):

- 1986 Kotak Mahindra Finance Limited starts the activity of Bill Discounting
- 1987 Kotak Mahindra Finance Limited enters the Lease and Hire Purchase market
- 1990 The Auto Finance division is started
- 1991 The Investment Banking Division is started. Takes over FICOM, one of India's largest financial retail marketing networks
- 1992 Enters the Funds Syndication sector
- 1995 Brokerage and Distribution businesses incorporated into a separate company - Kotak Securities. Investment Banking division incorporated into a separate company - Kotak Mahindra Capital Company
- 1996 The Auto Finance Business is hived off into a separate company - Kotak Mahindra Prime Limited (formerly known as Kotak Mahindra Primus Limited). Kotak Mahindra takes a significant stake in Ford Credit Kotak Mahindra Limited, for financing Ford vehicles. The launch of Matrix Information Services Limited marks the Group's entry

- into information distribution.
- 1998 Enters the mutual fund market with the launch of Kotak Mahindra Asset Management Company.
- 2000 Kotak Mahindra ties up with Old Mutual plc. for the Life Insurance business. Kotak Securities launches its on-line broking site (now www.kotaksecurities.com). Commencement of private equity activity through setting up of Kotak Mahindra Venture Capital Fund.
- 2001 Matrix sold to Friday Corporation
Launches Insurance Services
- 2003 Kotak Mahindra Finance Ltd. converts to a commercial bank - the first Indian company to do so.
- 2004 Launches India Growth Fund, a private equity fund.
- 2005 Kotak Group realigns joint venture in Ford Credit; Buys Kotak Mahindra Prime (formerly known as Kotak Mahindra Primus Limited) and sells Ford credit Kotak Mahindra.
Launches a real estate fund
- 2006 Bought the 25% stake held by Goldman Sachs in Kotak Mahindra Capital Company and Kotak Securities

Currently, the group has a net worth of over Rs. 5,824 crore, employs around 20,000 people in its various businesses and has a distribution network of branches, franchisees, representative offices and satellite offices across 370 cities and towns in India and offices in New York, London, San Francisco, Dubai, Mauritius and Singapore. The Group services around 4.4 million customer accounts (www.kotak.com).

Kotak Group Companies and their business:

Following are list of Kotak Group companies along with their brief description (http://www.kmpl.com/aboutus/kotak_group.htm):

Kotak Mahindra Bank

The Kotak Mahindra Group's flagship company, Kotak Mahindra Finance Ltd which was established in 1985, was converted into a bank- Kotak Mahindra Bank Ltd in March 2003 becoming the first Indian company to convert into a Bank. Its banking operations offer a central platform for customer relationships across the group's various businesses. The bank has presence in Commercial Vehicles, Retail Finance, Corporate Banking, Treasury and Housing Finance.

Kotak Mahindra Capital Company

Kotak Mahindra Capital Company Limited (KMCC) is India's premier Investment Bank. KMCC's core business areas include Equity Issuances, Mergers & Acquisitions, Structured Finance and Advisory Services.

Kotak Securities

Kotak Securities Ltd. is one of India's largest brokerage and securities distribution houses. Over the years, Kotak Securities has been one of the leading investment broking houses catering to the needs of both institutional and non-institutional investor categories with presence all over the country through franchisees and coordinators. Kotak Securities Ltd. offers online (www.kotaksecurities.com) and offline services based on well-researched expertise and financial products to non-institutional investors.

Kotak Mahindra Prime

Kotak Mahindra Prime Limited (KMP) (formerly known as Kotak Mahindra Primus Limited) has been formed with the objective of financing the retail and wholesale trade of passenger and multi utility vehicles in India. KMP offers customers retail finance for both new as well as used

cars and wholesale finance to dealers in the automobile trade. KMP continues to be among the leading car finance companies in India.

Kotak Mahindra Asset Management Company

Kotak Mahindra Asset Management Company Kotak Mahindra Asset Management Company (KMAMC), a subsidiary of Kotak Mahindra Bank, is the asset manager for Kotak Mahindra Mutual Fund (KMMF). KMMF manages funds in excess of Rs 16,100 crore and offers schemes catering to investors with varying risk-return profiles. It was the first fund house in the country to launch a dedicated gilt scheme investing only in government securities.

Kotak Mahindra Old Mutual Life Insurance Limited

Kotak Mahindra Old Mutual Life Insurance Limited is a joint venture between Kotak Mahindra Bank Ltd. and Old Mutual plc. Kotak Life Insurance helps customers to take important financial decisions at every stage in life by offering them a wide range of innovative life insurance products, to make them financially independent.

Kotak Asset Reconstruction Division (ARD)

To better identify the revenue opportunities for Kotak ARD from FCCBs it is important to first get ourselves acquainted with the current operation of various sub-divisions within the department. Kotak ARD operates with 4 sub-divisions viz. Resources, Recovery, Single Assets Group and Advisory Group.

Resources

Information collected and analyzed on the basis of interview with Rahul Srivatsa (Relationship Manager - Resources)

Function and objective

The function of the resources team is to acquire a portfolio of NPA accounts.

Operational process

The selling bank offers to auction a portfolio of NPA assets via advertisements in papers. The banks interested in the buying the portfolio has to execute an expression of interest. The selling bank then executes a non-disclosure agreement after which they share the information about the accounts. All the documents available with selling bank are made available to interested banks so as to enable them to carry out the due-diligence process. The due- diligence process will involve majorly financial and legal due diligence. Legal due-diligence involves identifying the value of the underlying security, class of security, verification of title of security etc

Value of underlying security undermines the price to be offered since this will enable the determination of price to be offered. There are 5 classes of security: primary, collateral, personal guarantee, corporate guarantee and pledge of shares. In case of term loan primary security is land, building. Working capital will have stock or other current assets as securities. Also, the type of charge is important i.e. whether the selling bank has a 1st charge or parri-passu charge on securities offered. 1st charge is what the buying bank is most comfortable with. Also, land as security is preferred. Valuation is done by in-house valuation agents. Since the process is more towards recovery of debt the company is already in distress and hence financial due-diligence is not extensive. Potential Profitability and margin rarely form a part of financial due-diligence process. The current status of the case file against the borrower is important. As per the law as soon as the default is committed by any party the bank gets eligible to file a suit for recovery against the defaulter in debt recovery tribunal (DRT). Where the suit has been filed whether the recovery certificate, stating the amount to be recovered by the bank, has been received by the selling bank is to be considered by the buying authority. This will determine the time of recovery. After the due-diligence process the buying companies present their bids and the investor with the highest bid gets the portfolio. On confirmation of the bid the selling bank executes a deed of assignment where the debt is assigned to the buyer with transfer of all the privileges and restrictions with respect to the debt.

Recovery

This is the actual revenue earning department for the bank with respect to portfolio of NPA accounts bought. After the process of acquisition of NPA accounts by Resources team, recovery

team follows up the clients in default with the intention to recover as much as possible. To help the cause the general trend is not to include the amount paid on acquisition of NPA accounts in the Deed of Assignment. This enables the recovery team to go for maximum recovery without any preconceived notions. In one of the cases a debt bought for Rs. 76000 recovered Rs 120 million. This was possible since the recovery team was aware of only gross amount originally recoverable and not the acquisition sum agreed by the Resources team.

Single Assets Group (SAG)

Information collected and analyzed on the basis of interviews with Vaibhav Kargaonkar (Vice President – SAG), Trupti Sawant (Chief Manager- ARD) and Sonal Agarwal (Chief Manager-ARD)

Function/objective

The objective of the group is to fund the companies and work with the promoters so as to cause a turnaround. While working on the normal NPA acquisition and recovery process, Kotak ARD realized that many of the NPAs provided the opportunity of a turnaround. These accounts were capable of revival. Hence, Kotak came up with a concept of Single Asset Group which functions to fund individual companies in distress rather than operating on a portfolio of NPAs. Investment is made in the companies in order to work with the promoters with an intention to cause a turnaround. Investment is generally in the form of debt (NPA) buyouts at a discount. This is same as normal debt buyout, the only difference being the concentration on single assets/NPAs rather than on portfolio of assets. Also, return for this department is not in the form of recovery but via high yield to maturity (interest rate + upside on equity funding). Kotak ARD also extends this type of funding to standard and sub-standard assets.

Operational process

Unlike funding by other departments, distress funding at Kotak does not require sourcing by any marketing division. Distress companies themselves or via consultants approach kotak for buyout or additional influx of funds. The deal, just like private equity funding, starts with first cut discussion with the promoters of distressed company to understand the preliminary understanding of the product, business potential, profitability, requirement of funds and initial

agreement on terms of transaction. This is followed by a preparation of a note for In-principal approval by the Vice President. The note will mention the details discussed in the first meeting and also have a client's brief financial details and the sector analysis. In-principle approval is granted if the Vice President is, after fundamental analysis of the financials details in the note, satisfied that the proposal is prima-facie doable. Extensive due diligence process follows up involving legal and compliance due diligence with respect to applicable laws, financial due diligence involving verification of accounting assertions and projections for future years, sensitivity analysis, adequacy of security available for hypothecation, title search etc. A note on the basis of above findings is prepared for final approval which also details an optimum investment structure (mix of debt and equity) and if satisfied, approval is granted. The deed of assignment is then executed between the existing lender (assignor) and Kotak (assignee). The debt is assigned via the execution of deed of assignment and Kotak steps into the shoes of the existing lender. Another document, Consent Terms, is executed between the client and Kotak with respect to alteration of the terms contained in the Deed of Assignment. E.g. there can be security enhancement over and above the security granted to the earlier lender, the amount and repayment period can be rescheduled etc. Further, where there is additional influx of funds in the company the approval will also be followed by a sanction letter containing terms and conditions of additional funding.

Financial model

Over the years SAG group has identified certain parameters to classify the companies as units in distress. These parameters include:

EBIDTA Margin

EBIDTA margin i.e. Earnings before interest, taxes, depreciation and amortization signifies operational efficiency of the company and a good EBIDTA margin also indicates the ability of the company to service debt in future. Kotak expects EBIDTA, which represents operational cash flows of the company, to be at least 10% of the sales in ideal cases. However, other positive factors can sometimes cause Kotak to accept cases having EBIDTA less than 10%.

PAT

Profit after tax (PAT) is generally negative for companies in distress. This is due to burden of finance charges on existing debt and amortizations on assets.

Analysis of the all the above 2 factors combined above imply that Kotak is generally accepts cases which have positive EBIDTA but is not able service debts due to heavy finance charges. Thus, these units are generally operationally efficient/ potential efficient but in losses due to heavy finance costs.

Further, there are other secondary parameters exhibiting distress situation briefed as follows:

Low capacity utilization

The existing capacity might be underutilized which might be a reason for distress. This is generally the case where demand of the product in the market has been quite short of expectations on which debt was initially raised. This reduced demand may be due to reasons as faulty projections, change in government regulations, strategic errors etc. In such cases there ought to be pressure on the companies since the existing debt is not utilized efficiently to justify its serviceability. One of the measures of capacity utilization is Fixed Assets/Total assets to sales Ratio. This ratio for every company is compared with the industry standards.

Liquidity crisis

This is due to shortage of working capital since a huge portion of it goes into finance costs. Further, liquidity is also affected due to slow moving of stocks, non-recovery or late recovery from debtors and accumulation of current liabilities other than capital providers. This can be verified from Debtors/Creditors/Stock Turnover ratio.

On the basis of above parameters a case study based on hypothetical figures is presented, as under, to get a clear picture of the cases taken by the Kotak ARD:

	Profit and Loss Account				
	2004	2005	2006	2007	2008
Sales	100,000	90,000	75,000	60,000	40,000
EBIDTA	15,000	12,000	8,000	5,000	3,000

EBIDTA %	15	13.33333	10.66667	8.333333	7.5
Interest	4500	4500	4500	4500	4500
Depreciation	2,000	1,800	1,620	1,458	1,312
PBT	8,500	5,700	1,880	-958	-2,812
Tax@30%	2550	1710	564	-287.4	-843.6
PAT	5,950	3,990	1,316	-671	-1,968

Balance sheet

	2004	2005	2006	2007	2008
Fixed Assets	20,000	18,000	16,200	14,580	13,122
Current Assets	50,000	45,000	40,000	47,500	50,000
Current Liabilities	20,000	18,000	18,000	16,000	15,000
Net Current Assets	30,000	27,000	22,000	31,500	35,000
Total	50,000	45,000	38,200	46,080	48,122

Secured lenders	37,500	33,750	30000	32500	36000
Net worth	12,500	11,250	8,200	13,580	12,122
Total	50,000	45,000	38,200	46,080	48,122

Interest Coverage

Ratio	3.333	2.667	1.778	1.111	0.667
Fixed Assets					
Turnover	5	5	4.62963	4.115226	3.048316

Note:

1. Depreciation has been taken at 10% on written down value of the asset at the end of the year.
2. Interest has been charged at 12% on secured lending.

3. Interest Coverage Ratio = $\text{EBIDTA} / \text{Interest} * 100$

4. Fixed Assets Turnover = $\text{Sales} / \text{Fixed Assets} = \text{No. of times}$

Above is the typical case of a distressed firm where the company suffers from reduced sales over the period of 5 years. This has led to reduced EBIDTA margin from 15% for the FY 2004 to 7.5% for the FY 2008 since many fixed cost are incurred despite reduced sales e.g. administration expenses. Further, though EBIDTA is positive for all the years PAT is negative for last 2 years. This is due to the burden of finance charges. This is evident from Interest Coverage Ratio which drops from over 3 for the FY 2004 to 0.67 for the FY 2008.

Analysis of Balance sheet reveals lower capacity utilization of available resources evident from Fixed Assets Turnover Ratio which reduces to 3 times for the FY 2008. Also, the current assets which initially reduce with reduced sales increases back despite continuous reduction in sales due to increased bad debts, loans and advances and dead inventory. Current liabilities are maintained more or less at the same level making liquidity position very weak for the company. The result is the default with existing lenders evident from secured lender balance which increased from Rs.30000 for the FY 2006 to Rs.36000 for the FY 2008 due to non-payment of principal amount in full and partial interest charges. Thus, the liquidity crunch situation led to non-fulfillment of debt obligations.

Kotak SAG looks out for specific reasons attributable to such losses which can be cured. Thus change in government policy regarding distribution of goods can be one of the major factors, for example, which can lead to working capital crunch situation causing default.

As we can see, EBIDTA for last 2 years is below 10%. Despite this Kotak SAG will take up the above case if the business potential exists evident from factors like good brand name enjoyed by the company and current or potential rapid industry growth expected by Kotak SAG.

Required Return on investment

The existing business model of Kotak SAG expects a return of minimum 25% -30% on every investment. Such a high rate of return is achievable due to 2 important factors:

Consent Terms

The intention of Kotak SAG is to work with the promoter for a turnaround wherein both the parties (Kotak SAG and the client) are benefitted. Kotak achieves this objective by sharing of gains received from debt buyout. This is done in the manner explained below:

Suppose there is debt buyout of Rs.1000 million from another bank. This is not a portfolio buyout but a typical company in distress. This debt is generally bought at a discount say at 30% of the original value i.e. Rs.300 million (since these are NPAs for the selling bank they willingly sell it at a discount). Assume the original debt carried an interest of 12%. Therefore, annual installments including interest due for the client is Rs. 320 million (interest =12% of 1000 million + principal amount= 200 million if the loan is for 5 years) which being too burdensome for the client has caused defaults. Here, Kotak SAG executes a Consent Term sheet wherein the original debt obligation of the client is reduced and interest rate being set in such a way that both the parties are at an advantage. This would depend on Internal rate of return (IRR) required from the debt investment. Suppose IRR is 20%. Hence, yearly installments would be calculated as follows:

Annual yearly installments = Amount Invested/Cumulative return for 5 years for Re.1 @discounting rate of 20%

Now, the amount invested = Rs.300 million

Cumulative return is calculated in following table:

Year	Discounted return @20%
1	$1/1.2 = 0.833$
2	$0.833/1.2 = 0.694$
3	$0.694/1.2 = 0.579$
4	$0.579/1.2 = 0.482$

5	$0.482/1.2 = 0.402$
	Total = 2.99

Thus, the annual yearly installments = $30/2.99 = \text{Rs.}100.3$ million

Thus, the annual yearly installments have reduced by Rs. 220 million (320 million-100.3 million) and at the same time Kotak SAG has earned 20% return on its investment. Hence, due to above arrangement both Kotak and the client are at an advantage. However, Kotak SAG desires a return of minimum 30% which, most of the times, is not possible via only debt funding. The above return of 20% is extended to reach above 30% via a debt-equity arrangement as seen below.

Debt-Equity funding

The business model would not have been viable if it involved only debt or only equity funding. Firstly, on only debt funding the return can be limited (20% in our case above) as it would lead to obligatory outflow of cash so the bank would prefer it to keep it limited so that the liquidity position is not adversely affected. Secondly, only equity funding in a distress company would be too risky and thus, insane. Thus, there is always need of proper debt-equity mix to have the desired risk-return ratio.

As seen above debt buyout will lead to 100% debt funding. But these distress companies most of the times will require additional funding to bail them out from liquidity crunch. This additional funding is generally in form of new debt and equity warrants issued by the company.

A warrant is an instrument that gives the holder the right to buy or sell the underlying share for an agreed price, on or before a specified date (<http://www.investopedia.com/terms/w/warrant.asp>). An equity warrant can be a call or a put warrant. A call warrant gives the holder the right to buy the share and a put warrant gives the holder the right to sell the share. Kotak SAG makes optimum use of call warrant instrument in its deals. Only so many warrants as would constitute 10% of the total warrants issued are generally

exercised at the inception along with debt funding so as to fulfill the entire funding requirements. Thus, where Rs. 400 million funding is made by Kotak the structure will be as follows:

Debt buyout: Rs. 300 million

New debt funding: Rs.60 million

Funding via exercise of warrants: Rs.40 million

This further implies that total value of shares (as on the day of funding) under warrants shall be: Rs 40 million*100/10 = Rs.400 million

The agreed price here is the price in the market at the time of funding. Remainder 90% warrants are exercised by kotak just before the end of the term of investment. Thus, where investment period is 5 years the remainder will be exercised a month before the exit. At the time of exit the shares acquired under warrants are then sold off in the open market. This forms the second source of return for Kotak SAG. Since the warrants are exercised at the price during the initial funding any equity upside (difference between the price as at funding date and at exit date) is a gain for SAG. Also, at the time of exercise it will be a new source of funds for the company enabling them to pay off the debts of the bank during exit.

Thus, interest on debt and equity upside both are the sources of return for SAG giving them the desired return of more than 30% IRR.

Additional security

The amount of security desired by SAG for its funding is generally 200% of the funds provided. This is due to the extent of risk assumed in funding distress companies. Where the original security under Deed of Assignment is not as per satisfaction of SAG (e.g. it may be subject to second charge or pari-passu charge) it may require the client to perfect the existing security or/and provide additional collateral security. The effect to this clause will be specified in Consent Terms.

Advisory Group

Information collected and analyzed on interview with Vaibhav Korgaonkar (SAG – Vice President, Ex-Associate- Advisory Group)

This department is concerned with financial and management advisory services. Where SAG itself funds the companies, Advisory thrives on fee income as their major source of revenue. Thus, where SAG itself causes a turnaround Advisory Group works as an agent providing various turnaround solutions via interaction with existing lenders, management and legal authorities. It basically deals with restructuring services including Debt restructuring, Corporate restructuring and Business Restructuring. Further, it also provides Accounting, Taxation and Legal Advisory services as support services. Further, it does not work only for companies in distress but all the companies requiring advisory services with respect to the target function in question.

The functioning can better be understood with the case study of one of the companies which has been in receipt of Advisory services sometime back. It is as under:

The company had a high debt of Rs. 1200 million. Net worth had eroded and the company was registered with BIFR (Board for Industrial and Financial Reconstruction) for revival. There was severe working capital crunch and the existing lenders alleged non-cooperation by the company. There were also concerns with corporate governance. Here, the advisory group managed the entire revival process as follows:

It reinstated dialogues with existing lenders to understand their concerns and expectations. The group explored all possibilities of financial support including remission of interest payment, remission of repayment period, cheaper sources of refinance etc. The group introduced governance in the company by first convincing the promoter to step down from Board of Directors. Professionals (Mr. S.N.Talwar, Dr. Srinivasan) were appointed to review operations and provide solutions for operational wastage. Crawford Bayley were appointed as Legal Advisors. RSM (Ratan S. Mama) & Co. were appointed as joint statutory auditor. Haribhakti & Co. were appointed for valuations. To solve the working capital crunch situation and revive the

operations Kotak Mahindra Bank provided the funding like any other regular bank at market rate of interest.

Section 2

In search of a new business model

Kotak SAG acts a vulture fund, identifying new opportunities which can align with their existing business model discussed above. One of such potential opportunities includes Foreign Currency Convertible Bonds (FCCBs).

Foreign Currency Convertible Bonds (FCCBs): A Literature Review

In the last five years, over 130 Indian companies have raised more than \$20 billion (Rs 800,000 million) in FCCBs (<http://www.financialexpress.com/news/FCCB-overhang-crisis-breeds/312380/>). FCCBs have become an attractive and an alternative source of financing for Indian companies in search of cheap finance. But what are these FCCBs?

As given by Investopedia, FCCBs are a type of convertible bonds issued in a currency different than the issuer's domestic currency. In other words, the money being raised by the issuing company is in the form of a foreign currency (<http://www.investopedia.com/terms/f/fccb.asp>). Foreign Currency Convertible Bonds are attractive to both investors and issuers. The investors receive the safety of guaranteed payments on the bond (if interest payment is involved) and are also able to take advantage of any price appreciation in the company's stock. Bondholders take advantage of this appreciation by means of warrants attached to the bonds, which are activated when there is substantial price appreciation of the stock. Due to the equity side of the bond, the coupon payments on the bond are lower, thereby reducing its debt – financing costs for the issuer. FCCBs are also referred as FCCNs (Foreign Currency Convertible Notes) by some issuers. Bonds of foreign countries are called by various names in International markets. For example in US, overseas bond listed with SEC are called Yankee Bonds, while they are referred to as Bulldog Bonds (in U.K.) and Samurai Bonds (in Japan). (http://www.icai.org/resource_file/10351703-708.pdf)

FCCB is a quasi-debt instrument, which can be converted into a company's equity shares if the investor chooses to do so, at a pre-determined strike rate. FCCB issues have a 'Call' and 'Put' option to suit the structure of the Bond. A call option entitles the issuer to "Call" the loan and make an early redemption.

On the other hand, a put option entitles the lender to exercise the option to convert the FCCB into equity; both the options are subject to RBI guidelines. The interest component or coupon on FCCBs is generally 30 per cent-40 per cent less than on normal debt paper or foreign currency loans or ECBs. This translates to cost saving of approx 2-3 per cent per annum. The coupon on bonds can also be zero as in case of zero Coupon Bonds (ZCB) in view of attractiveness of options attached to them. In case of ZCB, the holder is basically interested in either conversion of the bonds in equity or capital appreciation. The redemption of FCCB can be made at a premium or at par or even at a discount depending upon the coupon offered. The Yield to Maturity (YTM) in case of FCCBs normally ranges from 2 per cent to 7 per cent. **FCCB are generally issued by Corporate, which have high promoter shareholding and hence do not perceive any risk of losing management control even after exercise of conversion option.**

The FCCB holder opts to convert the FCCB, in case the market price exceeds the option price or if there is intent to make strategic investment by the lender irrespective of the stock price in market. In many cases, the FCCB issuer as well looks forward to exercise of option by lender, so that there is no fund outflow on redemption. Instead the issuer's reserves are inflated by receipt of premium. If however, the FCCB holders do not opt for conversion, the Issuer has either to reissue the bonds to same holder or scout for a new lender. This also gives an opportunity for debt restructuring. The foreign holder of FCCB can trade the FCCB in part or in full. That is to say, the holder can sell the debt part while holding the Option; or vice versa. For example, if the holder is a mutual fund, interested only in equity, it may retain the conversion option and sell the Bond, with a call option to, say, a bank who does not want to take equity risk. The Bank thus buys debt portion of the FCCB and draws a fixed income till the bond is called up. The seller still retains the benefit of equity and can call up when stock price is substantially less than the conversion price - without sacrificing the liquidity. The issuance of FCCB like any incremental borrowing invariably requires the approval of existing consortium of lenders. FCCB can be secured as well as unsecured. Most of the FCCB issued by Indian Companies are generally

unsecured. FCCB can be subordinated to existing debts or they can be unsubordinated on case to case basis depending upon the structure of the deal, its timing and the present gearing. FCCB can be converted into Indian Shares or American Depository Shares (ADS). The allottee is free to dispose of the shares so received upon conversion any time after allotment, if there is no lock in clause. FCCB issue expenses as well as premium on redemption of FCCB are generally charged to Securities Premium Account. While a credit rating of Bonds is not mandatory, since Bonds are mostly issued by top corporate having excellent track record, rating definitely helps to price the Coupons competitively. The issuing company needs to hedge its Forex exposure arising out of FCCB, till the time of redemption or conversion. The right to convert the FCCB into equity can arise any time, starting immediately after allotment and can vest for 2-3 years. FCCB carries fewer covenants as compared to a syndicated loan or a debenture; hence these are more and more convenient to raise funds. FCCB are generally listed to improve liquidity, generally Indian issuer have listed at Singapore Stock Exchange and in many cases also on Luxembourg Stock Exchange.

http://www.icai.org/resource_file/10351703-708.pdf

FCCB are treated as Foreign Direct Investment (FDI) by Government of India. The latest comprehensive guidelines on FCCB are contained in external commercial borrowings (ECBs) guidelines issued by RBI on 1st August, 2005 vide circular no 5 A.P. (DIR Series). The circular is fully applicable for FCCB issuance as well

<http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=2402&Mode=0>.

Section 3

Brainstorming the options with FCCBs

Option 1: Buy-out FCCBs at a discount

Initial idea of Kotak SAG is to Buy-out the FCCBs at a discount, similar to their other debt buy-outs, from the FIIs i.e. to fund these FIIs. However this is possible only if FIIs are under some pressure to release them at a discount. A feasibility check on this idea is given as under:

Liquidity crunch faced by FIIs:

Sub-prime crisis that US in the March 2007 has disastrously affected liquidity of many financial institution with the result that they have offloaded their investments in emerging markets including India.

India's Finance Minister P Chidambaram in March 2008 predicted that the fallout of the subprime crisis on the global credit and housing markets would impact India. In his words "When crisis has moved from the subprime mortgage market to the housing market, and now the housing market to the credit market, there is impact upon India. There is impact in terms of credit flows and financial flows." (<http://www.financialexpress.com/news/FM-subprime-crisis-to-hit-India/285571/>)

The prediction proved to be accurate. As per the report in Business Standard published on 3rd August 2008 foreign institutional investors were the major sellers on the Indian bourses in the last six months, accounting for total outflows of Rs 620,000 million. The table below shows the list of top FIIs and their selling between the period December 2007 and June 2008:

Name of the FIIs	Shares sold
	Amt (Rs million)
Citi Group Global	67,670
Morgan Stanley	51,680
Swiss Finance	50,760
Merill Lynch Cap	44,690
Goldman Sach	42,090
Copthall Mauritius	27,310
JP Morgan Asset	19,960
CLSA	17,020
HSBC Global	16,150

BSMA	12,510
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Source: <http://www.business-standard.com/india/storypage.php?autono=330303>

Citigroup, which reported around losses of \$18 billion in the sub-prime crisis, reduced its holdings in 47 companies to below one per cent in the last six months. It sold shares of NIIT, Idea Cellular, HCL Technologies, Jet Airways, Bharti Airtel and Suzlon Energy during the period. **Bear Stearns Asset Management (BSMA)**, which reported losses of \$3.2 billion, sold most of its stake in Indian companies. It offloaded shares of GTL, HCC, Sterlite Technologies, Adlabs Films, Shipping Corporation, Aurobindo Pharma and KPIT Cummins Infosys in the last six months. BSMA's holdings in as many as 50 companies declined to sub-one per cent levels. (<http://www.business-standard.com/india/storypage.php?autono=330303>)

Morgan Stanley, Merrill Lynch Capital, HSBC, Goldman Sachs and Swiss Finance Corporation reduced their holdings in 30 companies to below-a-per cent each. It sold equity shares of MTNL, Zee Entertainment, Unitech and HDIL, while Merrill Lynch offloaded the shares of NIIT, Dabur Pharma, Reliance Capital and Reliance Infrastructure between January and June this year. Overall, the FIIs reduced their holdings in 515 companies between December 2007 and June 2008, out of which the stake in 275 companies was reduced by more than a per cent each. (www.business-standard.com)

Further, as per latest reports on 29th August 2008 in Business Standard Lehman Brothers has been selling its stake in various Indian firms due to write downs and credit losses of \$8.2 billion after the sub-prime crisis hit the US markets. Lehman Brothers Holdings, the fourth-largest US securities firm, reported a record \$2.8 billion second-quarter loss. It sold about \$130 billion of assets during the quarter. The bank reduced mortgage-related assets and leveraged loans by about 20 per cent. (<http://www.business-standard.com/india/storypage.php?autono=332909>).

Thus, liquidity crunch caused in FIIs cause them to pullout their equity investments in Indian market. This liquidity crunch has exerted the required pressure on FIIs to release their FCCB holdings at a discount. However, due to the following reasons the option seems unreasonable:

1. FCCB is already a liquid instrument which is being listed and actively traded on Singapore stock Exchange or Luxemburg Exchange or London Stock Exchange. So FIIs can anytime convert the instrument into cash.
2. Further, as seen earlier the rate of return required by Kotak SAG is 25%-30%. To achieve this return the debt needs to be bought-out at a huge discount (around 40%-50% of the face value) so as to pass on some benefit to the issuer of the debt instrument as well. This is possible only when the company issuing the instrument goes in distress during the life of the debt. This is a rare possibility with FCCBs as the companies issuing them are fundamentally sound and even more so since the instruments are unsecured.
3. As conformed by some of the companies issuing the instrument, since the instrument is traded across the world over, even the company itself is not aware of the existing holder of the instrument. The information can be had only through the depository or the custodian of the concerned stock exchange.
4. To acquire instruments denomination in foreign currency Kotak SAG will have to adhere to regulations relating to Transfer of Foreign Security under Foreign Exchange Management Act, 1999. The above mentioned transaction will also be a Capital Account transaction under the said Act and thus, subject to timely approvals of Reserve Bank of India. This is a cumbersome task of Kotak SAG which is not specialized to handle foreign exchange laws and transactions.
5. Further, hedging of risks related to foreign exchange fluctuation will require additional attention and cash outflow on account of forward premium in case of forward contracts.

The above problems associated with the 1st option bring us to the next and only option left i.e. funding the Indian companies.

Option 2: Finance the Indian companies

Here, the intention is to fund the Indian Companies to repay the FCCBs on maturity. A feasibility check on this option is as under:

Pull-out of equity investments by FIIs:

As mentioned earlier, due to liquidity crunch faced by FIIs there has been huge sell out of equity investments in Indian Market by these FIIs. Shareholding pattern of many Indian companies indicate good proportion of stakes by FIIs. Of the companies listed on National Stock Exchange (NSE), 149 companies have foreign fund holding exceeding 20%. In 100 companies, foreign institutional investors (FIIs) own over 25% of the equity (<http://www.indiaonline.com/company/discorpnews.asp?storyId=7112005003&lmn=4&tbl=news>). Following table shows the number of companies listed on NSE with the % foreign holding:

% Foreign Holding	No. of companies
0	288
0.01 to 5	385
5.01 to 10	178
10.01 to 15	116
15.01 to 20	74
20.01 to 25	49
25.01 to 50	95
50.01 and above	5
Total	1190

Source: <http://www.capitalmarket.com/cmedit/story11-43.asp?sno=232661>

When these FIIs sell their stakes, there is detrimental effect on the target company stock price and also on the stock market as whole. Thus, Orchid Chemicals & Pharmaceuticals declined by a whopping 45% in just two days as Bear Stearns sold its holding in the company (<http://www.capitalmarket.com/cmedit/story11-43.asp?sno=232661>). Further, the BSE (Bombay Stock Exchange Sensex), declined 34.92 per cent from its January high of 21,206 points to 13,800 levels in June 2008 (<http://www.thehindubusinessline.com/2008/07/01/stories/2008070152091600.htm>). As pointed out by Rajesh Jain, at Pranav Securities in Mumbai, the steep stock-market decline has been

driven by heavy selling by foreign institutional investors or FII's. Holdings are concentrated in the hands of large FII's who sell any quantity on a single day. To absorb that kind of quantity there are no ready buyers at all times, and both long-term buyers and speculators are absent from the market (<http://www.voanews.com/english/archive/2008-06/2008-06-09-voa23.cfm>).

Since there has been a huge pull-out by FIIs, companies that issued FCCBs with a conversion price set at a very high premium (till 2007 the market was on a constant rise so prices for many companies have been set high on speculative basis) **might** have not been able to get their instruments converted into equity. Thus, the result being that on maturity these companies will have to face huge redemption pressure. Most of the companies issue FCCBs with an intention to get it converted with 2-3 years time. Although, the annual finance charges hardly put up any pressure on the company while servicing the debt (since most of FCCBs issue by Indian companies are either Zero Coupon or 1% or 1.5% instruments as seen later in the paper), redemption of FCCBs at a premium will affect the companies. Thus, these companies **might** require additional funds to refinance the redemption of existing FCCBs. Here, Kotak can provide the requisite funds.

Further, not only Kotak can fund for redemption but also for **prepayment** (it is possible that the companies might go for pre-payment of the FCCBs in certain situations discussed later in the paper). Here, reference can be had to the ECB/FCCB guidelines which states that prepayment of FCCB is permitted up to US\$200 Million subject to compliance of minimum average maturity period. For higher prepayment amount, RBI approval is needed. Now, guidelines also state that minimum Average Maturity of FCCB shall be 3 years for borrowing up to US\$ 20 million and 5 years in case it exceeds US\$ 20 Million (<http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=2402&Mode=0>).

Thus, the option seems to be feasible for Kotak. **However, it is not feasible for Kotak SAG since the Yield to Maturity (YTM) required by SAG, as mentioned earlier, is around 25%-30%.** With FCCB refinancing SAG can just operating as regular local bank lending money secured on company assets. Kotak does have a foreign arm which can lend money at a higher YTM since cost of funds in developed economies is low. However, even this arrangement will not get SAG the required YTM. E.g. the cost of funds to the foreign arm is, say, 3% Per annum.

Now, even if this sum is lent at 15% p.a. the spread is just 13% which does not serve SAG's purpose.

Thus, both the options are not viable for Kotak SAG. However, 2nd option will definitely work for another department of Kotak ARD i.e. Advisory department which can arrange funds for the company from other lenders for refinancing or prepayment.

Thus, the next step will be identification and analysis of companies in which Kotak Advisory can render such arrangement to those companies.

Section 4

Identification and Analysis of companies

List of companies issuing FCCBs has been displayed on Reserve Bank of India website www.rbi.org. This list has formed the base for identification of the companies at the primary level. Of the all the companies 15 were selected for analysis, most of them from the year 2005. Year 2004 and earlier years have not been the base of our analysis since most of the FCCBs will be due in 2009 or earlier and thus, presumed to be converted by the year 2007 (since stock market decline began in January 2008 and FCCBs generally get converted in 2-3 years time) and latest by the current year. However, one company Wockhardt Limited is taken from the year 2004. Similarly, two companies Tata Motors Ltd. and Subex Ltd. are taken from the year 2006. All the companies issuing FCCBs in 2007 will have to go for redemption (if not converted) in 2012 which is quite distant and hence not used for our analysis.

Of the 14 companies, with 5 there are no outstanding FCCBs as on 31st March 2008 and as such all of the FCCBs have already been converted. The list of these companies along with amount of FCCBs issued and maturity period is given as under:

Year	Company Name	Amount (Million Rs.)	Maturity period
Apr-05	NIIT Ltd.	10	5 years 2 mths
Aug-05	Maharashtra Seamless Ltd.	75	5 years 1 month
Sep-05	PSL Ltd.	40	5 years
Dec-05	Elecon Engineering Company Ltd.	18	5 years
Dec-05	Prajay Engineers	15	5 years

The analysis of remaining 9 companies is shown below which will include the details of FCCBs issued by the companies till date and identification of outstanding FCCBs, analysis of prospects of conversion, extent of redemption burden and consequently the need of refinance, promoter holding pre and post conversion and change in equity base and finally, the conclusion and recommendation for Kotak with respect to opportunities of funding in each company. The objective is to identify the ways in which the clients can be approached by Kotak for additional funding. Meanwhile, a primary level of distress analysis is also done simultaneously so as to identify any opportunity for SAG department. Level of Profit after Tax (PAT) and EBIDTA analysis will for the base for distress analysis.

Study and analysis of Aurobindo Pharma Ltd.

Details of FCCBS issued

As per Directors Report and Notes to Accounts, during the FY 2005-06 the company had issued 60000 zero coupon FCCBs for \$1000 each. These bonds are redeemable at a premium of 39.954% of its principal amount on the maturity date, or in whole at any time on or after February 25, 2008 and on or prior to August 1, 2010. Each bond is convertible into 83.12 fully paid equity shares with par value of Rs.5 per share at a fixed price of Rs.522.036 per share, on or

after September 20, 2005 but prior to close of business hours on August 8, 2010 (http://www.aurobindo.com/docs/ar2006/full_book.pdf).

Further, as per the FY 2007-08 Annual Report US\$ 4.5 million FCCBs out of the above issue were converted into 374,046 Equity Shares of Rs.5 each at a premium of Rs.517.036 (Rs.522.036-Rs.5) on July 11, 2007 as per the terms of the issue (http://www.aurobindo.com/images/ar_2008_full_book.pdf). **Thus, as on 31st March 2008 outstanding bonds are 55,500.**

Again, during the FY 2006-07 (as evident from notes to Accounts) Company has further issued 200,000 FCCBs aggregating to US\$ 200 million. Out of these, convertible bonds (Tranche A) of US\$ 150 million are convertible at any time on or after June 27, 2006 up to May 10, 2011 into Equity Shares of Rs.5 each for each bond at a conversion price of Rs.1,014.16. The balance of US\$ 50 million (Tranche B) are convertible at any time on or after May 17, 2007 up to May 10, 2011 into Equity Shares of Rs.5 each for each bond at a conversion price of Rs.879.13. Tranche A Bonds and Tranche B Bonds are redeemable at 146.285% and 146.991% respectively of its principal amount on the maturity date. Each Tranche A bond will be converted into 44.52 fully paid equity shares.

As on 31st March 2008, these bonds are not being converted (as evident from the Annual Report for the FY 2007-08). **Thus, of the total FCCBs issued only 4,500 bonds have been converted and all others amounting to \$255 million are outstanding.**

Analysis of Future Prospects of conversion

The current stock market price as on 29th August 2008 is Rs.314.70 (<http://money.rediff.com/money/jsp/company.jsp?companyCode=12540244&tabId=3>) which stood at Rs.291.35 as at 31st March 2008 (<http://www.moneycontrol.com/stocks/companydetails/histdata.php>). So there has been no remarkable spurt in the stock quotes to match the agreed conversion prices of Rs.522, Rs.1014 and Rs.879 which are far too ahead of the existing prices. Further, dramatic increase in price is not expected in near future due to higher inflation and oil prices. India's wholesale price index

(WPI)-based inflation rate surged to a new 16-year high of 12.63 percent in the 12 months to August 9, 2008 while just a year ago the annual rate of inflation stood at 4.24%. (<http://in.ibtimes.com/articles/20080821/india-inflation-wpi-cpi-oil-fuel-rbi-repo-crr-interest-rate.htm>). Further, inflation is expected to be in double digits till February 2009, as discussed later in the paper. Similarly, oil prices soared above \$146 per barrel on July 3, 2008 (<http://www.newsminer.com/news/2008/jul/03/oil-hits-new-record-above-145/>). With FIIs pulling out investments and Indian economy going weak markets are not expected to show a huge upside in the near future. So conversion seems to be hypothetical within the maturity period.

Profitability and distress check

Existing and potential financial situation will determine the role of either Kotak Advisory or SAG department's catering to the company needs and Kotak's new source of revenue.

Our distress criteria, discussed earlier, clearly stated that PAT should be negative. Currently, Profit after Tax for Aurobindo for last 3 financial years is given below:

Rs. (million)

	2005-06	2006-07	2007-08
Sales	14722	19797	22347.3
EBIDTA	2046.6	3217.3	4355.5
Profit After Tax (PAT)	693	2290.8	2907.8

However, the above profit does not factor the interest costs attached to the Zero Coupon Bonds. A loophole in the Companies Act, 1956 allows companies to charge the interest on FCCBs and certain other types of non-convertible bonds directly against reserves on the balance sheet rather than against the profit and loss account, as is the case with 'regular' debt. The loophole appears in Section 78 of the Companies Act, which deals with how companies can use the securities premium account of the balance sheet. Typically, companies that issue shares to investors have to transfer any premiums earned on the share issue to the securities premium

account (SPA). However, the section also says that companies may use the account in ‘providing for the premium payable on the redemption of any redeemable preference securities or debentures of the company’. Since the redemption premium in case of FCCBs is nothing but the accumulation of interests (as the coupon rates are as low as Zero) the redemption premium should be expensed over the period of maturity. But Indian Companies argue that since these are convertible instruments and they expect most of it will be converted it is not a legitimate option to charge potential interest to annual Profit and Loss Account. The issue arises when these instruments are not being converted like in the case above wherein Profits get inflated due to no charge of interest against profits even when redemption seems to be the most likely event to happen. Further, VSNL’s US GAAP report for 2004-05 states that while Indian rules allow the redemption premium to be written off against the securities premium account, “under US GAAP, these costs would be amortized by the interest rate method over the life of the FCCB” (www.businessworld.in/index.php/All-in-a-Name.html). This seems to be a correct accounting treatment, especially for non-conversion cases. Hence Profit after Tax (taking a before tax interest rate of 6%) can be recalculated as follows:

	2005-06	2006-07	2007-08
Profit After Tax	693.8	2290.8	2907.8
Less: Interest (Refer Note1,2,3)	-74.95	-444.37	-430.31
Adjusted Profit After Tax	618.85	1846.43	2477.49

Note: Calculation of interest (after a tax saving @30% on account of tax deduction available under Income tax Act):

1. Outstanding FCCBs at the end of FY2005-06 = Rs. 2677.2 million

Tax adjusted Interest @6% for 8 months from August 2005 = $2677.2 * 6\% * 8/12 * 70\%$ = Rs.74.95 million

2. Outstanding FCCBs at the end of FY2006-07 = Rs.11,299.6 million

Tax adjusted Interest @6% for the year on Rs 2677.2 million = $2677.2 * 6\%$ = Rs.112.43 million

Tax Adjusted Interest @6% for 11 months from May 2006 on Rs 8622.4(11,299.6-2677.2) = $8622.4 * 6\% * 11/12 * 70\%$ = 331.94 million. Thus, total interest = 112.43+331.94 = Rs. 444.37 million

3. Tax Adjusted Interest @ 6% for 12 months on FCCBs outstanding of Rs 10,245.6 at the end of FY 2007-08 = $10,245.6 * 6\% * 70\%$ = Rs.430.31 million

Thus, true profitability can be shown only after factoring interest costs, as shown above. This will then affect all the profitability ratios linked to PAT like Net Margin, Earnings Per Share (EPS) etc. **This will, however, not impact the cash flow condition of the company since interest accounting in this case does not result in any outflow of cash and hence will not cause a distress situation even if PAT becomes negative as per our distress criteria.** Thus, since (even after adjustment of interest) PAT is positive for last 3 years the company is **NOT** in distress currently. Further, the company has also enjoyed increased sales and EBIDTA Year on Year basis for last 3 years as shown in the above table taken from its annual accounts.

Extent of Redemption Burden

Redemption in 2010 of 55,500 bonds at 139.954% at an exchange rate of 1\$ = Rs.43.65 on 29th August 2008 (<http://www.x-rates.com/d/INR/USD/data120.html>) = $55,500 * \$1000 * 139.954\% * 43.65$ = Rs.3337 million approximately.

Redemption in 2011 of 150,000 bonds at 146.285% = $150,000 * \$1000 * 146.285\% * 43.65$ = Rs.9578 million. Redemption in 2011 of remaining 50,000 bonds at 146.991% = $50,000 * \$1000 * 146.991\% * 43.65$ = Rs.3208 million. Thus, total outflow on account of redemption will be Rs.16,123 million (3337+9578+3208).

As per the Profit & loss Accounts, Net Cash Profit can be calculated as follows:

	Rs.(million)		
Profit After Tax	693	2290.8	2907.8

(PAT)			
Add: Depreciation	511.2	718.4	746
Cash Profit	1204.2	3009.2	3653.8

To calculate potential cash earnings we take the average of last 3 years cash earnings. Thus, Average cash profit of last 3 years = $(1204.2+3009.2+3653.8)/3 = \text{Rs.}2622.4$ million

Thus, Cash outflow on redemption/average cash profit = $16,123/2622.4 = 6.14$ times. **Thus, the outflow will weaken the liquidity and capital investment position since it will eat up the cash earnings of more than 6 years.**

Thus, the company might face liquidity problems, as seen above, if one time redemption is called for on maturity.

Effect of conversion on Promoters holding

Though, generally, FCCBs are issued with an intention for it to get converted there might be a situation where it is advisable for promoters not to get it converted since conversion will cause dilution of their stake in the company and if the existing stake is low it might even cause the risk of hostile takeover. As claimed by SP Tulsian FCCBs can be an instrument for hostile takeovers or change of management if the existing promoters holding is abysmally low to about 15% to 20%. The classic case study here can of Orchid Chemicals, which had issued FCCB of US \$ 175 million in late 2007, having conversion option at Rs.348.335 per share. Till 31st March 08, nobody would have imagined to convert them into equity as the share price was hovering around Rs.150 per share. Since these FCCB holders would be entitled to receive about 20 million equity share of the company, which amounts to about 23% of the post-issue equity of Rs.860 million, any acquirer having an eye on Orchid would go ahead with this conversion. The attraction gets added if the promoter's stake is low, which is, in this case is at about 16%. In view of share price of Orchid ruling at around Rs.150 per share, in March 08, acquisition of close to 12% stake, of pre-issue equity of Rs.660 million, made the share price to rise to Rs.230 levels. Hence, this 12% stake, which is about 9% of post FCCB conversion equity, would give control of about 32% stake to a prospective acquirer at an average rate of Rs.307 per share

<http://www.premiuminvestments.in/cover-feature/11638p106/11558.html>). By simple majority in Extra-Ordinary general meeting change of management is then possible; since most of the Indian companies now have FIIs holding good % of their equity their support can cause a change in management.

Where this is the case, it shall be easier for the Advisory department of Kotak Bank to induce the promoters not to go for conversion option. **The pain is not much for the promoters where FCCB conversion would eventually lead to below 10% increase in equity and where promoters have a stake of 20% and above.** But the pain increases for converse cases <http://www.premiuminvestments.in/cover-feature/11638p106/11558.html>). The effect of conversion on promoter shareholding of Aurobindo Pharma can be seen below:

Promoters, directors and their relatives shareholding as on 31st March 2008 = 29,727,843 shares. Total shares outstanding as on 31st March 2008 = 53,765,268 shares. Thus, % shareholding of promoters = 55.29%. However, Note 22 on Earnings per Share in the Annual Report for the FY 2007-08 gives the dilution effect of conversion of FCCBs wherein 13,858,708 shares will be further added to the current lot on account of conversion. Thus, the total number of shares after conversion = 53,765,268 + 13,858,708 = 67,623,976.

Therefore, post conversion % shareholding of promoters = $29,727,843/67,623,976 * 100 = 43.96\%$. Thus, though after conversion promoters holding will be diluted by 11.33% (55.29-43.96) promoters holding will still be at a reasonably high level of 43.96%. Thus, dilution effect will **NOT** be detrimental on the promoter holding and cannot be a source of hostile takeover or change management.

Conclusion and Recommendation

As per the above analysis, although the existing profitability is on a progression and promoters would be in favour of conversion due to high post-conversion holdings, huge difference in the stock value of the company with respect to the conversion prices will not cause the conversion. Hence, there can be a situation of liquidity crunch at the time of redemption due to high redemption premium. In such a situation the company has two options:

1. To go for bank borrowing locally in Rupee terms.

2. To go for ECB funding in foreign currency. Here reference can be had to **ECB guidelines** wherein the end usage restrictions both under approval and automatic route clearly state that ECB/FCCB funds **cannot** be used for repayment or refinancing of **rupee loan** (<http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=2402&Mode=0>). Thus, ECB funding **can be used for financing the existing FCCB** repayment denominated in foreign currency.

Both the above sources shall be secured on company assets since FCCBs are originally unsecured.

In conclusion, though SAG department cannot make much out of present and potential condition of Aurobindo Pharma Ltd due to absence of any distress situation, Advisory department can approach the company to arrange for ECB funding (since interest rate is lower than under rupee loan) secured on company assets.

Study and Analysis of Leela Venture Ltd.

Details of FCCBs issued

As evident from the directors report and Notes to Accounts of the Annual Report for the FY 2007-08, the company has allotted 1% FCCBs of Euro 60 million on 15th September 2005 having maturity of 5 years and 1 day convertible anytime after 8th November 2005 and upto 31st August 2010 into equity shares at a conversion price of Rs. 62.2 for each share of Rs.2. These bonds are listed on Singapore stock exchange. Up to 31st March 2008, holders of 8.60 million bonds have exercised their right of conversion and have been allotted 9,312,522 equity shares. Of these, 6.55 million bonds were converted during the FY 2007-08 in January 2008 by allotting

7,521,907 equity shares.

(http://www.theleela.com/images/leela_annual_rpt_08.pdf)

Remaining 51.40 million bonds, if not converted or cancelled before maturity, will be redeemed on 16th September 2010 at a premium of 25.50% of the principal amount.

Also, in April 2007 the company issued and allotted 1000 zero coupon FCCBs of USD 1,00,000 each aggregating to \$100 million. These are convertible into equity shares of Rs.2 each at a conversion price of Rs.72. If the bonds are not converted they will be redeemed on 25th April 2012 at 146.61% of the principal amount (http://www.theleela.com/images/leela_annual_rpt_08.pdf). **Up to 31st March 2008 all the bonds under this category are outstanding.**

Prospects of conversion

The stock as listed on Bombay Stock Exchange had a closing price of Rs.32.15 as on 29th August 2008 (<http://money.rediff.com/money/jsp/company.jsp?companyCode=16560006&tabId=3>). As at 31st march 2008, the closing price was Rs. 40.15 (<http://www.moneycontrol.com/stocks/companydetails/histdata.php>). Thus, last 6 months have seen a fall than increase in the market price although the net margin for the company stands high at 25.65% as at 31st March 2008 and net profit for the quarter ended June 2008 stands at Rs.334.3 million as against Rs.301.6 million for the corresponding period in the FY 2006-07. This is because the company has a lower P/E ratio with respect to its counterparts. PE ratio as at 17th September 2008 is mere 7.75 whereas Indian Hotel company enjoy PE multiple of around 12 as on the same day. Again EIH Ltd. has a PE ratio of 26.74 (http://money.rediff.com/money/jsp/compare_chart.jsp?codes=16560006a16560002). With the markets dipping consistently it is difficult for the company to catch up with the conversion prices of 62.2 and 72 with the current P/E levels since a sudden spurt in earnings is not expected as evident from the past years financials discussed later. However, company has invoked a 'Reset Clause' wherein the conversion price of 62.2 has been revised to 47. Also, the all the conversions in the last year has been made at the revised price. 47 levels is not outside the reach if markets bounce back a bit and with 2 years maturity time still left the possibility of conversion cannot be ruled out. With respect to the Lot with the conversion price of Rs.72 still 4 years time is left for maturity and so any assumption about the future prices is futile. Thus, there is no clear justification for non-conversion and hence conversion is possible.

Existing profitability of the company and distress check

Adjusted Net Profit After factoring the interest costs:

Rs. (million)

	2005-06	2006-07	2007-08
Reported Net Profit After Tax	731.1	1262.4	1191.6
Less: After Tax Interest (Refer Note1,2,3)	48.98	88.15	283.69
Adjusted Profit After Tax	682.12	1174.25	907.91

Note:

1. For the FY 2005-06 on outstanding bonds of Rs.3230 million interest @ 4% for 6.5 months where tax saves is 30% = $3230 * 4\% * 6.5/12 * 70\% = 48.98$
2. Similarly, for the FY 2006-07 interest = $3148.4 * 4\% * 70\% = 88.15$
3. For the FY 2007-08 interest on 2 separate classes of bonds = $2792.5(6987-4194.5) * 4\% * 70\% + 4194.5 * 7\% * 70\% = 78.19 + 205.5 = 283.69$

Thus, since PAT is positive for all the 3 years (both before and after the adjustment) company is not in distress. Further, both Reported Net Profit and Net margin have reduced in the FY 2007-08. Net margin has reduced from 31.43% for the FY 2006-07 to 25.65% for the FY 2007-08. Further, though Net Profit has increased by almost 10% for the quarter ended June 2008 with the corresponding quarter in the previous year from Rs.301.6 million to Rs.333.43 million Net Profit margin has reduced from 29.15% to 26.16% indicating that increase in sales has caused less than proportionate increase in absolute net profits causing a decline in Net Margin. Thus, sudden spurt in earnings with the current results is not expected at least for the FY2008-09.

Redemption burden

If not converted then, redemption cost of bonds in 2010 @ exchange rate of 64.1 would be = $51.40 * 125.5\% * 64.1 = \text{Rs.}4134.49$ million. Redemption cost in 2012 at an exchange rate of 43.65 would be = $100 * 146.6\% * 43.65 = \text{Rs.}6399.09$ million. Thus, the total redemption cost would be Rs.10534.08 million. (4134.99+6399.09)

Calculation of cash profit:

As per the Profit & loss Accounts (http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc_id=HLV), Net

Cash Profit can be calculated as follows:

Rs.(million)

Profit After Tax (PAT)	731.1	1262.4	1191.6
Add: Depreciation	324.5	337.5	453.4
Cash Profit	1055.6	1599.9	1645

Thus, potential cash earnings based on average cash profits of last 3 years = $(1055.6+1599.9+1645)/3 = \text{Rs.}1433.5$ million.

Thus, Cash outflow on redemption/average cash profit = $10434.08/1433.5 = 7.27$ times. **Thus, the outflow spread over 2 years will weaken the liquidity position since it will eat up the cash earnings of at least 7 years presuming the average current level of earnings.**

Promoter holding and increase in equity base

Number of shares held by promoters as on 31st March 2008 is 188088544 which constitutes 49.8% of the total shareholding (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=16560006>). Total number of shares issued = 377.824 million. On conversion 51.40 million bonds = $51.40*54.33/47 = 59.41$ million shares. Conversion of 100 million bonds = $100*41.945/72 = 58.256$ million shares. Therefore total shares = $59.41+58.256+377.824 = 495.49$ million. Thus, promoter holding = $188.08/495.49 = 37.98\%$. Increase in equity base = $495.49-377.824 = 117.66$ million shares which shall be 31.14% ($117.66/377.824*100$) of pre-conversion equity and 23.76% ($117.66/495.49*100$) of post conversion equity. Thus, though increase in equity base is more than 10% promoter holding is still comfortably above 20% and hence there is no risk of change management due to conversion.

Conclusion and recommendation

There is good possibility of conversion with the Rest Clause available with the company where the prices can be reset by again invoking the clause. However, **lower the conversion price more will be the number of shares issued and thus lowering the promoters holding even further.** So promoters can be kept interested in having debt funds in future than go for further dilution in equity by again invoking the Reset Clause in future. Also since a dramatic spurt in earnings is not expected the cash outflow on redemption may prove detrimental to company's liquidity if the bonds do not get converted. **Since distress situation is not present SAG will not find any room for revenue but Advisory department can arrange for ECB funding secured on company assets.**

Study and Analysis of SpiceJet Ltd

Details of FCCBS issued

As per the Annual Reports, during the FY 2005-06 the company issued Zero Coupon **Secured** Foreign Currency Convertible Bonds (FCCBs) of the face value of US \$ 1,00,000 aggregating to US\$ 80 million. As per terms of the issue, the holders have an option to convert the FCCBs into equity shares at an initial conversion rate of Rs.90 per equity share at a fixed exchange rate conversion of Rs. 46.12 to US\$ 1 from December 7, 2005 to November 11, 2010. **The conversion price is subject to certain adjustments.** Further under certain conditions the bondholder has the option for early redemption in whole but not in part. Unless previously converted, redeemed or purchased and cancelled, the company will redeem these bonds at 140.499 percent of the principle amount on December 13, 2010. The issue was fully subscribed by two investors, namely, Istithmar PJSC and Goldman Sachs Investments (Mauritius) I Ltd, who were allotted 375 and 425 bonds, respectively. The Bonds are listed at the Luxembourg Stock Exchange. (<http://www.report.capitaline.com/2007/3367-07.pdf>)

The Reset Clause was invoked in 2007 and the conversion price of Rs. 90 per equity share has been revised to Rs. 57 per equity share during the period ended March 31, 2007 with all other conditions remaining unchanged.

All the bonds were still outstanding as on 31st march 2008 as evident from the quarterly reports.

Prospects of Conversion

The stock as listed on Bombay stock exchange shows a price of Rs.27.30 as at 29th August 2008 while the price was Rs. 40.8 as on 31st March 2008. However, the price earlier reached Rs.94.80 during the month of January 2008 (<http://www.moneycontrol.com/stocks/companydetails/histdata.php>). The falls in stock prices can be attributed to the reduced profitability due to the oil price shoot up since January 2008 and lower passenger traffic. Prices of the fuel have risen from Rs.47,444.14 per kl in January 2008 to Rs66,226.66 in June. Even as airlines have passed on the rise in jet fuel prices through what fuel surcharges levied on air tickets, load factors or the average number of people carried per plane has fallen accompanied by a decelerating growth compared with the past few years. SpiceJet's load factors for May were 72% down from 77.3% in the same month last year (<http://www.livemint.com/2008/06/30225709/SpiceJet-follows-other-airline.html?d=1>). This led to Net Losses of Rs. 1335 million for the FY 2007-08 which increased by more than 85% from the previous year losses of Rs.721 million. Of the losses in the FY 2007-08 over Rs 1100 million was lost in the last quarter of that fiscal when oil prices had started shooting. Further, the company again declared losses of Rs. 1020 million for the first quarter ended 30th June 2008, again due to further spurt in fuel prices. However, the entire industry is in sulk and not just the SpiceJet. Jet Airways (India) Ltd, which runs an eponymous airline and JetLite Ltd, reported losses of over Rs.2530 million in fiscal 2008. Simplifly Deccan that is operated by Deccan Aviation Ltd, now controlled by the UB Group which also owns Kingfisher Airlines Ltd made losses of some Rs. 6436.4 million in the nine months to March (the company's financial year ends in June) . Thus, the entire airline industry has fallen on hard times due to rising oil prices which make up 45% of an airline's operating cost (<http://in.reuters.com/article/marketsNews/idINDEL375620080830>). Due to above reasons it is difficult for the company to get its bonds converted even at the reset price of Rs.57 since the company is not expected to recover from continuous losses unless bailed out by additional funds and hence the market prices will be lower than the reset price.

Profitability and distress situation of the company

The company is into losses since last 5 years as under:

	2003-	2004-	2005-	2006-	2007-
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	04	05	06	07	08
Net Profit After Tax	-3.1	-28.71	-47.29	-67.38	-133.51
EBIDTA	-2.76	-27.31	-34.69	-57.81	-113.13

Source: http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc did=SJ01

These losses will further widen up if interest cost on FCCBs is factored into the total costs. Thus, the company is in distress. However, the company is not a typical distress company that Kotak looks out for since EBIDTA is negative too signifying that the company is in trouble not due to burden of finance charges but due to operational inefficiency.

Redemption burden

If the \$80 million bonds are redeemed at 40.99% premium and at an exchange rate of Rs. 43.65 the total cash outflow on redemption would be = \$80 million*140.499%*43.65 = Rs. 4906.2 million

Since the company is already into losses since last 5 years and cash flow also being negative it is very difficult for the company to arrange for the redemption amount from internal funds and hence financing the redemption sum from external sources is the only option available with the company.

Promoters holding

Existing shareholding of promoters = 31.07 million shares which constitutes only 12.91% of the total current shareholding (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=16600005>). If FCCBS are converted at a predetermined exchange rate of Rs.46.12 and conversion price of Rs.57 then total number of shares will be increased by 64.72 million shares (\$80 million*46.12/57), which is already more than the current holding of promoters. Further, the converted shares are even more than the shares subscribed by the Body Corporate(s) holding 55.16 million shares which currently account for around 22% of the total current holdings. **Thus, in this case promoter's position in the management is at risk and any new acquirer can initiate change of management just by acquiring FCCBs and converting them.**

Conclusion and Recommendation

SpiceJet Limited has Reset Clause which can be invoked again. But, then this will further risk the promoters' position which is already at a risk. Further, even other shareholders (other than promoters having high stakes) might not agree for further dilution due to lowering conversion price if reset clause is invoked again. Here, **Kotak SAG** has **two** options. **Firstly**, SAG can treat the company as a distress firm and work with the promoters causing a turnaround since the fuel prices have started to reduce considerably just recently and so company might get a boost with the plunge in fuel prices due to recession and fall in demand for fuel worldwide. On 15th September 2008 oil prices tumbled below \$93 per barrel due fall in demand (http://www.businessweek.com/ap/financialnews/D937VUJG0.htm?campaign_id=rss_daily). So there is a possibility of a turnaround although the company does not exactly fit into the distress criteria of SAG. SAG can itself refinance the company during redemption. Here, the refinancing shall again be in the form of both equity and debt to have the desired return on investment. **Secondly**, since the company is in distress the FCCBs will be trading at very low level at the Luxemburg exchange. These can be purchased by SAG either as investments or to have a management controls if higher stake is purchased. Advisory also has **two** options. **Firstly**, it can arrange for refinance of redemption via ECB secured on company assets. **Secondly**, it can also approach the company for arrangement of refinance for prepayment of debt instead of waiting for conversion since promoters' stake is at risk. However, in the second case it might be difficult for the company to sustain the finance charges incurred on ECBs while already in losses.

Study and analysis of Subex Ltd.

Details of FCCBS issued

During the year 2006-07, the Company issued Foreign Currency Convertible Bonds (FCCBs) aggregating to US\$ 180 million to Institutional Investors. The bonds carry an initial interest rate of 2% per annum and are redeemable by March 9, 2012, if not converted in to equity shares as per terms of issue. Other terms and conditions governing the bonds are as follows:

- a) Bonds can be converted into equity shares at the option of the bond holders at any time after 18th April 2007.
- b) Conversion Price – Rs.656.20 per share
- c) Exchange Rate for purpose of

conversion - 1 US\$ = Rs.44.08 d) Interest is payable at 2% per annum e) Redemption with yield to maturity guaranteed return of 8% per annum f) The Company can exercise an option to redeem the bonds in whole or in part on or any time after 9th March 2010, but prior to 29th January 2011, subject to appropriate approvals at a price determined on the terms defined in the offer document. g) The bonds are listed on the Professional Securities Market of London Stock Exchange. (<http://www.report.capitaline.com/2007/14155-07.pdf>)

The difference between the yield to maturity guaranteed rate of return of 8% and the coupon rate of 2% stated above represents the due premium payable on redemption and is charged to Securities Premium over the life of the bonds.

Thus, the company does not have any Reset Clause with respect to its conversion price. **Further, currently all the bonds remain outstanding.** (<http://www.report.capitaline.com/2008/14155-08.pdf>)

Prospects of Conversion

The stock as listed on Bombay stock exchange (BSE) was quoted at Rs. 97.95 as at 29th August 2008 while the conversion price is Rs.656.20 per share. Thus, current market price is just 14.9% ($97.95/656.20*100$) of the conversion price. This difference is quite substantial. The market price as at 30th March 2007 was Rs. 564.05 while as at 31st March 2008 the market price was Rs.202.60 (http://www.moneycontrol.com/stocks/company_info/pricechart.php?sc_did=S15). Thus, since 30th March 2007 till 29th August 2008 the prices have fallen by 82.6% ($(564.05-97.95)/564.05*100$). The falls in prices can be attributed to annual results for both the years. For the FY 2007-08, the company has posted a net loss of Rs 681 million whereas it reported a gain of Rs 675 million (on consolidated basis) for the FY 2006-07. This can be attributed to the doubling of personnel cost from Rs 2070 million in 2007 to Rs 4070 million in 2008 and to the increase in interest payout by four times to Rs 320 million resulting in an operating loss for the full year at Rs 617 million (<http://www.business-standard.com/india/storypage.php?autono=321539>). During April 2007, it acquired Syndesis, a Canadian telecom products firm, worth more than \$150 million (around Rs 6000 million). Subex relied on external resources to fund this deal and hence the interest cost grew.

Whilst revenues have grown rapidly as a result of its new acquisitions (Net sales has gone up by 45.7 per cent to Rs 5400 million in FY08), costs have also grown sharply. Subex anticipated a \$12 million synergy from its acquisition of Syndesis but could realize the gain only in fourth quarter of FY 2007-08. Subex registered operating losses in the first, second and fourth quarter of FY2007-08, and registered only a modest operating profit in Q3. The business gave the following reasons for its poor performance over the year:

- Postponement of an order worth US\$20m with telecom giant AT&T;
- Issues with execution resulting in lower revenue recognition in continuing business;
- Lower growth in order intake due to challenges with integration; and
- A fixed cost base minimal variability
(http://revenueprotect.com/community/eric/blog/2008/05/subex_suffers_big_losses)

Subex, which provides clients such as British Telecom Plc. and T-Mobile Systems solutions to improve productivity and respond faster to their customers, had initially forecast its fiscal 2008 revenues from its product business at around Rs.615 million and net profits at Rs.1550 million at the beginning of the current fiscal.

Following a squeeze in revenues from a top client, AT&T Inc. in the US, which postponed capital spending, Subex revised its annual product revenue forecast to Rs5200 million and net profit to Rs1040 million in the September quarter (<http://www.livemint.com/2008/03/16231759/Subex-to-miss-revised-earnings.html>). However, the year ended up with a Net Loss of Rs. 681 million, thus shattering the investors' confidence and hence the remarkable reduction in share price.

Currently, for the first quarter itself Subex has again suffered losses of Rs.656.4 million largely due its foreign currency notional loss arising out of restatement of FCCBs (<http://www.thehindubusinessline.com/2008/08/02/stories/2008080251810500.htm>). Though losses are not cash losses but notional expense Subex still will still find it difficult to match its new forecast of Profit after Tax of \$12 million for the FY 2008-09 given the current performance.

(http://revenueprotect.com/community/eric/blog/2008/05/subex_suffers_big_losses). Thus, investor confidence, which is already too, will be hampered again causing further fall in prices.

Since Subex Limited does not have any Reset Clause conversion seems extremely difficult with the current stock performance, though time to maturity is still 4 years.

Profitability and distress check

	2003-04	2004-05	2005-06	2006-07	2007-08
Net Profit After Tax	177.50	253.03	378.48	675.66	-680.75

Source: http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc_did=S15

Since PAT is positive and increasing for last 4 out of 5 years the company, though in trouble currently as discussed above, is not in distress. Since FCCBs are issued in March 2007, interest cost for the FY 2007-08 will only have to be factored. Further, since the company has already reported losses for the FY 2007-08 interest factoring will further widen the losses.

Interest cost and Redemption burden

If the \$180 million bonds are redeemed at around 30% approximately (6% YTM for 5 years) premium and at an exchange rate of Rs. 43.65 the total cash outflow on redemption would be = \$180 million*130%*43.65 = Rs. 10214.1 million. Further, bonds carry 2% interest per annum. So every year cash outflow on account of interest Rs. 157.14 million ($\$180 \times 2\% \times 43.65$) has to be borne by the company. This will further make the final redemption burden go heavier after 4 years since the company is running into losses currently.

Promoter Holding

Total number of shares issued is 34.84 million out of which only 8.85% is held by promoters which accounts for 3.08 million shares (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=13020096>). FIIs hold the maximum stake with 31.12%. Where bonds are converted new shares issued will be 12.09 million ($\$180 \text{ million} \times 44.08 / 656.20$). This is almost 4 times the promoters' holdings and can give easy entry to any outsider into the company's management ousting the promoters. This is a huge risk for promoters and calls debt funding than conversion.

Conclusion and Recommendation

As per our analysis, Subex seems to be in deep trouble since one year due to which there is substantial reduction in its share value from Rs.564 in March 2007 to Rs.97 in August 2008. Though the company is not in distress situation currently but can be in very soon if it not able to recover quickly from existing losses. **Hence, Kotak SAG can either make an entry now since the valuation is very low currently or wait till the company goes into distress;** both moves shall be subject to future viability of the business. Since the company is into losses and it is difficult for it to get its FCCBs converted in absence of Reset Clause, redemption will put excessive pressure on it, as seen above. **Thus, here Kotak Advisory can arrange for refinance on maturity. Further, since promoters holding is too low Advisory can even pitch in for refinancing the prepayment, subject to approval of RBI as per FCCB guidelines.**

Study and Analysis of Wockhardt Ltd.

Details of FCCB issued

As per Annual Report for the FY 2007-08, 108,500 Zero coupon Foreign Currency Convertible Bonds of USD 1,000 were issued in October 2004. Each bond is convertible by the holders at any time on or after 24 November, 2004 but prior to close of business on 25 September, 2009. Each bond will be converted into 94.265 fully paid-up equity shares with par value of Rs. 5 per share at a fixed price of Rs. 486.075 per share. Bonds are redeemable, in whole but not in part, at the option of the Company at any time on or after 25 October, 2007 but not less than seven business days prior to maturity date i.e. 25 October, 2009 as per the terms and conditions of the bonds mentioned in the offering circular. They are redeemable on maturity date at 129.578 percent of its principal amount, if not redeemed or converted earlier. (<http://www.wockhardtin.com/pdf1/2007/NotestoAccountsfortheYearEndedDec31,2007.pdf>)

All the above bonds are outstanding as at 30th June 2008, as evident from the quarterly reports.

Prospects of conversion

The market price of the stock listed on BSE index as at 29th August 2008 is Rs. 199.05 (<http://www.moneycontrol.com/stocks/companydetails/histdata.php>). The conversion price is thus more than double the current market price. Since the bonds have not been converted for last four years it is unlikely that in the dipping market the market price will catch up with the conversion price in just a year's time to maturity. Further, there is no Reset Clause so the price is fixed. Thus, redemption is the most likely event in this case.

Profitability and distress check

	2003	2004	2005	2006	2007
Sales Turnover	7658	8468	9631	1134.5	1236.8
Operating Profit	1580	2298	2706	2948	2774
Net Profit After Tax	1334	2078	2385	2135	2139

Source: http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc_id=W05

The above table clearly shows that company is not into distress and in fact performing well over the period of last 5 years. Sales turnover has increased Year on Year basis and so has the Net Profit (except in the year 2006), although the company's operating profits have dipped in a bit in the Year 2007. As seen in case of Aurobindo Pharma Ltd. interest cost factoring does not change the cash position it has not been calculated here to assess the distress situation.

Redemption burden

If 108,500 bonds of \$1000 each are redeemed at around 29.578% premium and at the current exchange rate of Rs. 43.65 the total cash outflow on redemption would be = $108,500 * 1000 * 129.578\% * 43.65 = \text{Rs. } 6136.84 \text{ million.}$

As per the Profit & loss Account, Net Cash Profit for last 3 years can be calculated as follows:

Rs. (million)

	2005	2006	2007
Profit After Tax	2385.0	2135.0	2139.0

(PAT)			
Add: Depreciation	242.0	348.0	345.0
Cash Profit	2627.0	2483.0	2484.0

Thus, potential earnings measured by Average cash profit for last 3 years = $(2627+2483+2484)/3$
= Rs.2531 million

Therefore, Outflow on Redemption/Average cash profit = $6136.84/2531 = 2.42$ times. Such an outflow is may not be harsh on the company considering consistent profits over the years. However, with the issue of FCCBs company expects it to be converted and when this does not happen it might put ad hoc pressure over regular functioning and capital investment activities due to redemption.

Promoter Holding

As at 31st December 2007, promoters were holding 80.58 million shares which constituted 73.64% of the total paid up capital. Total number of shares issued is 109.44 million (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=12540405>). If all FCCBs are converted new number of total shares = 10.22 million (1000 bonds*94.265). Thus, % promoter holding post conversion = 67.34 % (80.58/ (109.44+10.22)). Thus, dilution effect on promoter holding in this case is not critical.

Conclusion and Recommendation

The company is fundamentally sound with no risk of distress. Hence, SAG has no role. Further, promoter control is also not at risk and hence no question of prepayment since the company would wait as long as possible to get FCCBs converted. However, since time left to maturity is only one year **refinancing for redemption is the only opportunity that can be had by Kotak Advisory Group.**

Study and analysis of Amtek Auto Ltd.

Details of FCCBs issued

As per the Annual Reports, during the FY2004-05 in June 2005 company allotted 0.5% 150,000 of \$1000 each aggregating to US\$ 150 million. FCCBs are due for maturity in 2010 and are convertible into equity shares of Rs.2 at a conversion price of Rs.209.83 per share. During the year 2005-06, the Company issued 2,500 Zero Coupon Foreign Currency Convertible Bonds of US\$ 100,000 each aggregating to US\$ 250 million convertible into equity shares of the Company at the option of the investors. The new FCCBs will be initially converted into equity shares of the Company at the rate of Rs.458.64 per share. Yield to Maturity (YTM) with respect to 0.5% bonds and zero coupon bonds is 5.75% and 6% respectively (<http://www.amtek.com/QuarterlyReports/Q4-AAL-2007-08.pdf>).

Of the above, US\$17.5 million 0.5% bonds due in 2010 and all the zero coupon bonds due in 2011 are outstanding.

Prospects of conversion:

The market price of the stock as on 29th August 2008 is Rs. 177.40, as quoted on BSE index (<http://202.87.40.54/stocks/companydetails/histdata.php>). The price was Rs. 235.70 as at June 2008. Thus, market price is hovering around the conversion price of Rs. 209.83 for 0.5% FCCBs. Hence, prospects for conversion of 0.5% bonds are good with around 20 months time left to maturity. However, with respect to conversion price of Rs. 458.64 the market price is still quite away. Hence, \$250 million zero coupon bonds issued in the year 2006 will find it difficult to get converted since the price difference is huge and there is no Reset Clause which can be invoked.

Profitability and distress check

	2005-06	2006-07	2007-08
Reported Net Profit	1612.3	2379.9	2630.5
EBIDTA	2893.5	4116.3	4381.7

Source: http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc_did=AA01

As seen above, both EBIDTA and PAT are constantly on a rise. Hence the company is not in distress.

Redemption burden

YTM of 5.75% is inclusive of coupon rate of 0.5%. Hence, YTM on account of redemption premium = 5.25% (5.75%-0.5%). Thus, redemption premium is more than 5.25% per annum for 5 years (since YTM is the discounted yield) =26.25% (5.25%*5). Hence, taking redemption premium at 26.25% and current exchange rate of Rs.43.65 outflow on redemption of 0.5% bonds = \$17.5 million*126.25%*43.65 = Rs.964.39 million. Similarly, for YTM of 6% redemption premium will be more than 30% (6%*5). Thus, taking the least outflow at 30% premium, the total outflow = \$250 million*130%*43.65 = Rs.14186.25 million. Thus, total outflow on redemption = 15150.64 (964.39+14186.25).

As per the Profit & loss Accounts, Net Cash Profit can be calculated as follows:

Rs. (million)

	2005-06	2006-07	2007-08
Profit After Tax (PAT)	1612.3	2379.9	2630.5
Add: Depreciation	515.7	639.9	939.1
Cash Profit	2128	3019.1	3569.6

Thus, average cash profit = (2128+3019+3569)/3 = Rs.2905 million.

Thus, total outflow on redemption/average cash profit = 15150.64/2905 = 5.21 times. Thus, redemption outflow will take away earnings of 5-6 years with respect to average cash earnings (alternatively cash earnings only for the FY 2007-08 can also be used since profit is showing an increasing trend). This will definitely weaken their financial position if additional funds are not added.

Promoter holding

As on 30th June 2008 promoters held 48.29 million shares which constituted 34.25% of the total shareholding. Total number of shares issued is 140.99 million (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=10660001>). If the bonds are converted the increase in shares would be 28.60 million, as given by the Annual report for the FY 2007-08. Thus, promoters' holding post conversion = 28.47 % (48.29/ (140.99+28.60)). Thus, dilution effect is not too detrimental on promoter's holding. However, increase in equity base = 20.28% (28.60/140.99)

Conclusion and Recommendation

Thus, in absence of reset Clause the conversion on one of the set of bonds the conversion is difficult. Further, the company is profitable and on an upward progression and hence, not in distress. **So Kotak SAG has no opportunity here.** There is no risk to promoter holding on conversion and thus, prepayment cannot be initiated on this ground. However, since increase in equity base is substantial i.e. around 20% existing the company will have to serve a higher equity base which will be costlier for the company in case of increasing profits since higher the equity in the capital structure lower the benefits to the existing shareholders. This happens in a profitable scenario where a company might prefer to be highly leveraged than be stable since debt has to be serviced only at a fixed rate of interest leaving a bigger chunk of profits for less number of shareholders increasing EPS and consequently, the Market Price per Share (MPS). **Thus, since in case of Amtek Auto profits are on a constant rise prepayment on this ground can be initiated by Kotak Advisory on both the sets of bonds.** Also, since the redemption pressure will be huge with cash outflow on redemption being 5.21 times the average cash earnings **refinancing for redemption** becomes an automatic opportunity for Kotak Advisory.

Study and Analysis of Hikal Ltd.

Details of FCCBs issued

As per Annual Reports for the FY 2005-06
(<http://hikal.com/investors/pdf/Annual.Report.2006.pdf>) and FY 2007-08

(http://hikal.com/investors/pdf/annual_report2008.pdf), 12,000 0.5% Foreign Currency Convertible Bonds of USD 1,000 each aggregating to Rs. 479.76 million. These bonds are convertible at the option of the bondholder at any time on or after November 21, 2005 but prior to the close of business on October 10, 2010 at a fixed exchange rate of Rs. 44.93 per 1 USD and price of Rs. 745 per share of par value of Rs. 10 per share subject to adjustment in certain events i.e. issue of bonus shares, division, consolidation, reclassification of shares etc. The bonds are redeemable in whole but not in part at the option of the Company on or after October 21, 2008 and up and until seventh business day prior to October 21, 2010 if closing price of the Share is greater than 160 percent of the conversion price for a continuous period of 60 consecutive stock exchange trading days. Further, the bonds are redeemable on maturity date on October 21, 2010 at 132.56% of its principal amount if not redeemed or converted earlier.

Till the year ended March 31, 2008 there has been no conversion of bonds in to shares and thus, entire lot of \$12 million bonds is outstanding.

Prospects of conversion

Since there has been no splits and the bonus issue was in the year 2003 the conversion prices have not been reset

(http://www.moneycontrol.com/stocks/company_info/splits.php?sc_id=H05),

(http://www.moneycontrol.com/stocks/company_info/bonus.php?sc_id=H05). The stock price as quoted on BSE as at 29th August 2008 is Rs.484 while the price as on 31st March 2008 was Rs. 417.40 and as on September 23 2008 is Rs. 475

(http://202.87.40.54/stocks/cptmarket/pricechart.php?sc_id=H05). The reasons for such movement are discussed in next paragraph. Since none of the bonds have been converted yet in last 3 years and current price is still just 63% ($475/745*100$) of the conversion price the possibility of conversion is less. Further, Reset Clause is presumed (in absence of clear information) to pertain to only bonus, splits, consolidation and reclassification of shares. Thus, with respect to other market circumstances like market meltdown and substantial fall in stock price there seems to be no reset clause for price adjustments.

Profitability and distress check

	2005-06	2006-07	2007-08
EBIDTA	654.0	632.0	827.0
Reported Net Profit	414.0	338.0	498.0

Source: http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc did=H05

PAT for all the 3 years is positive. **Hence, the company is not in distress.** Further, there has been a reduction in both EBIDTA and PAT for the FY 2006-07. But the FY 2007-08 has been good for the company with both EBIDTA and PAT showing an increase of 47.33% and 30.85% over the FY 2006-07. Also, as per quarterly results, company posted a Net profit of Rs.106.7 for the quarter ended as against Rs.87.0 million for the corresponding period last year. **This increase and improvement in performance has resulted in share price rise after March 31, 2008.** However, global financial market stress due to fall-out of large investment banks (filing of bankruptcy of Lehmann Brothers, sell-out of Merrill Lynch, and conversion of Goldman Sachs and Morgan Stanley into retail banks), rising oil prices and inflation in India have all affected the rise in share prices. Thus after reaching the levels of Rs. 484 the price has again fallen to 475 levels. Thus, conversion possibility is dim.

Redemption burden

If all the bonds are redeemed on maturity and not converted before, cash flow on redemption \$12 million bonds at 132.56% and at an exchange rate of Rs.43.65 = Rs.694.34 million (\$12 million*132.56%*43.65).

As per the Profit & loss Accounts for last 3 financial years, Net Cash Profit can be calculated as follows:

Rs. (million)

	2005-06	2006-07	2007-08

Profit After Tax (PAT)	414	338	498
Add: Depreciation	147	154	184
Cash Profit	561	492	682

Thus, average cash profit for last 3 years = Rs.578 million $[(561+492+682)/3]$

Thus, cash outflow on redemption/average cash profit = $694.34/578 = 1.20$ times only. The company is into profits consistently and **so refinancing the redemption from internal funds will not be a hassle**. However, rate of earnings on equity shareholders funds for the FY 2007-08 = Net Profit/Equity shareholder funds = Net Profit/ (capital + reserves) = $498 / (150.8+1781.5) = 26.6\%$. This implies that if funds are utilized internally company will lose potential earnings at rate of 26.6%. Now refinancing from external sources will cost company only 5%-6% annually taking ECB as a source of funding. **Thus, company is better off financing from the external sources than internal funds since it will save the company around 20% earnings (26.6%-6%). This can serve as a vital instrument for Advisory department to induce the company to go for external refinancing during redemption.**

Promoter holding

As at 30th June 2008, promoters are holding 11.30 million shares which account for 74.96% of the total shareholding. Total number of shares issued is 15.05 million (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=12070070>). On conversion of bonds new shares issued will be 0.723 million shares ($\$12 \text{ million} * 44.93/745$) which shall be only 4.80% ($0.723/15.05$) of the existing total shareholding. This will not dilute promoters holding substantially nor will it cause substantial increase in equity base.

Conclusion and Recommendation

Hikal Ltd. is not in distress and so SAG has no opportunity. On the basis of our analysis conversion seems to be a distant possibility. However, redemption might not put the company under pressure since the redemption amount is small and cash profits of the company are positive every year. Hence, **the tool described above under the head “Redemption Burden”** can be

used by Kotak Advisory to go for external refinancing on redemption. Prepayment is not possible since promoter holding is not at risk. **Thus, here redemption refinance is the only option with Kotak.**

Study and Analysis of Tata Motors Ltd.

Details of FCCBs issued

As per Notes to Accounts in the Annual Report for the FY 2007-08, the company on July 31, 2003 issued 1% FCCBs of \$1000 each aggregating to \$100 million. The bonds are to be converted at a conversion price of Rs.250.745 at a fixed exchange rate of \$1=Rs.46.16. The bonds if not converted or redeemed earlier will be redeemed on maturity i.e. July 31, 2008 at 116.824% of the Principal Amount. Of the above, \$99.94 million bonds have been converted. Since the maturity date has already passed remaining bonds have been presumably redeemed and as such currently, **none of the bonds are outstanding.** (<http://ir.tatamotors.com/index.php?CardID=5>)

The company on April 27 2004 further issued Zero Coupon FCCBs of \$1000 each aggregating to \$100 million. The bonds are to be converted at a conversion price of Rs.573.106 at a fixed exchange rate of \$1=Rs.43.85. The bonds if not converted or redeemed earlier will be redeemed on maturity i.e. April, 27 2009 at 95.111% of the Principal Amount. Of the above, \$95.59 million bonds have been converted. **As on 31st March 2008, 4,441 bonds are outstanding.**

Again on April 27 2004 1% FCCBs of \$1000 each aggregating to \$300 million were issued by the company. The bonds are to be converted at a conversion price of Rs.780.40 at a fixed exchange rate of \$1=Rs.43.85. The bonds if not converted or redeemed earlier will be redeemed on maturity i.e. April, 27 2011 at 121.781% of the Principal Amount. Early redemption is not available in this case. **As on 31st March 2008, all FCCBs are outstanding.**

On March 20, 2006 Zero Coupon FCCBs of Japanese Yen 10,000,000 each aggregating to Japanese Yen 11,760 million were issued by the company. The bonds are to be converted at a conversion price of Rs.1001.39 at a fixed exchange rate of Re.1=JP Yen 2.66. The bonds if not

converted or redeemed earlier will be redeemed on maturity i.e. March 21, 2011 at 99.253% of the Principal Amount. Early redemption is available between March 20, 2009 and February 8, 2011. **As on 31st March 2008, all FCCBs are outstanding.** (<http://ir.tatamotors.com/index.php?CardID=5>)

Prospects of Conversion

The stock price as on 23rd September 2008 as quoted on BSE index is Rs.394.05 while the conversion levels of above 3 sets of bonds are 573.106, 780.40 and 1001.39. The stock price as on 31st March 2008 was Rs. 582.76 (http://www.moneycontrol.com/stocks/company_info/pricechart.php?sc_did=TM03). Thus, although conversion level of 573 seems to be within the reach the time to maturity is just 8 months which is insufficient for the market to climb up in the current market and economic situation. As per the article in Economic Times, only eight out of 30 Sensex companies posted higher growth in profit in June 2008 quarter than a year ago. However, majority of the companies (18) in the Sensex reported faster revenue growth than the corresponding period last year. This is attributed to rising prices rather than volume growth. Companies have not been able to pass on the rise in input prices to customers, as fewer companies are able to grow their profits than sales. The performance of companies like ACC, Maruti Suzuki and Tata Motors indicate that the manufacturing sector is facing the heat of rising input prices and flat volume growth. Both Maruti Suzuki and Tata Motors increased their sales realization per unit, but it was not sufficient to absorb rise in raw material prices. (http://economictimes.indiatimes.com/Market_Analysis/Inflation_drag_on_Sensex_Nifty_cos_in_June_quarter/articleshow/3330856.cms). Thus, though sales turnover increased from Rs. 60,568.2 million for the quarter ended 30th June 2007 to Rs. 69,284.4 million for the quarter ended 30th June 2008, Net Profit for the period has declined to Rs. 3261.1 million from Rs. 4667.6 million (<http://www.moneycontrol.com/india/stockpricequote/tatamotors/tatamotors/05/00/quarterlyresults/marketprice/TM03>). Further, Global rating agency Standard & Poor's expects inflation in India to remain in double-digit figure till February 2009 (http://timesofindia.indiatimes.com/Inflation_to_continue_in_double_digit_till_Feb_2009_SP/art

icleshow/3357185.cms). Thus, where the conversion levels of 573 seems to be a distant reality level of 780.40 and 1001.39 are way too away to be achieved within 2 years.

Profitability and distress check

	2005-06	2006-07	2007-08
Sales Turnover	200886.3	266642.5	287383.0
EBIDTA	29987.7	37008.9	37646.9
Reported Net Profit	15288.8	19134.6	20289.2

Source: http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc did=TM03

Thus, since PAT is positive and on an increase every year there is no situation of distress or potential distress. Further, since even EBIDTA is increasing with increase in Sales on Year on Year basis the company is also performing well operationally.

Redemption burden

As per the Profit & loss Accounts for last 3 years, Net Cash Profit can be calculated as follows:

Rs. (million)

	2005-06	2006-07	2007-08
Profit After Tax (PAT)	15288.8	19134.6	20289.2
Add: Depreciation	5209.4	5862.9	6523.1
Cash Profit	20498.2	24997.5	26812.3

Thus, average annual cash profit = Rs. 24102.66 million

Outflow on bonds due for redemption in 2009 = $4441 * 1000 * 95.111\% * 43.65 = \text{Rs. } 184.37$ million. Thus, outflow on redemption/average cash profit = $184.37/24102.66 = 0.0076$ times.

This is negligible and can be easily financed by the company through internal funds.

Outflow on two sets of bonds due for redemption in 2011 at an exchange rate of 1\$ = Rs.43.65 and 1Yen = Rs.0.40 (<http://www.exchange-rates.org/history/INR/JPY/T>) = \$300 million*121.781%*43.65 + Yen 11,760 million*99.253%*0.40 = 15,947 + 4668.46 = Rs. 20615.46 million.

Thus, outflow on redemption/ average cash profit = 20615.46/24102.66 = 0.86 times. Thus, although the ratio is on the lower side redemption payment in absolute terms is huge. Further, Rate of earnings on shareholder funds = PAT/(Equity + reserves) = 20289.2/(3855.4+74284.5) = 25.96%. Thus, since rate of earnings is much higher than cost of borrowing via ECB (around 5%-6%), it is advisable for the company to borrow than use internal funds.

Promoter Holding

As at 30th June 2008 the promoters held 128.77 million shares which constituted 33.40% of the total holdings. Total number of shares issued is 385.61 million (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=10510008>). On conversion increase in number of shares will be 21.26 million (16.85 + 4.41), as evident from the Annual Report for the classes of bonds due in 2011. Hence, promoters holding post conversion = 128.77/ (385.61+21.26) = 31.64%. Thus, dilution in holdings is even lower than 2%. Now, % increase in equity base = 5.51% (21.26/385.61). This is also lower than 10%. Hence there is no risk of change management or hostile takeover.

Conclusion and Recommendation

Tata Motors Ltd. is fundamentally sound and operating well. **Thus, SAG has no opportunity.** Further, since the profitability is restricted due to general economic conditions conversion in next 2 years is not on cards. Thus, Advisory **can pitch for redemption refinance on the grounds mentioned under “Redemption Burden”.** Further, since there is no risk of management change **Advisory cannot pitch for prepayment.**

Study and Analysis of Strides Arcolab Ltd.

Details of FCCBs issued

As per the Annual Report for the FY 2007, during the accounting year ending December 31, 2005, the Company had issued Foreign Currency Convertible Bonds (listed in the Singapore Exchange Securities Trading Limited, Singapore) to the extent of US\$ 40 Million. These bonds carry an interest rate of 0.5 % p.a. and are to be redeemed on April 19, 2010 (unless converted into Equity Shares) at 136.78% of the Principal amount. The Bonds may be redeemed in whole, but not in part, at the option of the Company at any time on or after April 18, 2008 but prior to April 19, 2010 with a redemption premium of 6.8% per annum (which is identical to the gross yield in case of redemption at maturity). The Bonds are convertible by the Bond holders into shares at any time on or after May 18, 2005 at an initial price of Rs. 358.70 per share with a fixed conversion rate of Rs.43.7767 = US \$ 1.00. The initial conversion price will be subject to adjustment by the Company for Bonus issue, division, consolidation and reclassification of shares etc as defined in the terms of issue of the Bonds. (<http://www.stridesarco.com/Docs/Strides%20Annual%20Report%20Final.pdf>)

As per the latest Quarterly Report for the quarter ended 30th June 2008, none of the above bonds had been offered for conversion.

Prospects for conversion

The price of the stock as quoted on BSE index as at 29th August 2008 is Rs.195.55. The stock price as on 31st March 2008 was 172.20 while the price as on 29th June 2008 was Rs. 141.75 (<http://www.moneycontrol.com/india/stockpricequote/pharmaceuticals/stride-arcoblab/12/29/SA10>). Thus, there has been a substantial increase in the stock price over last 2 months. The increase can be clearly attributed to improvement in performance of the company wherein the operating profits of Rs. 252.9 million is posted by the company for the quarter ended June 30, 2008. Though the company has posted as Net loss of Rs.488.4 million for the above mentioned quarter most of its losses are not operational but notional affected by forex loss and restatement of foreign currency convertible bonds (FCCBs) and External Commercial Borrowings (ECB) borrowings (<http://www.business-standard.com/india/storypage.php?tp=on&autono=42854>). This is definitely an improvement over earlier two quarters where company has reported Net losses. For the previous two quarters

of September-December and Jan-March the company has posted operating losses of Rs.431.7 million and Rs.0.7 million respectively and thus, the Net losses of Rs.1334.0 million and Rs.160 million respectively owing to losses in US operations, loss on sale of a non-core business (specialty chemical business) and surging rupee (<http://www.thehindubusinessline.com/2008/03/11/stories/2008031151090200.htm>). The company is recovering well currently and the loss making US operation too has been discontinued, the one-off write off on which has already been provided during the last quarter of FY 2007. However, with the Indian market still facing the heat of higher inflation (this will continue till at least next year as per S&P report mentioned earlier) and stock market meltdown conversion price of Rs.358.70 is difficult to attain in time left to maturity i.e. 18 months and hence **the conversion seems difficult but cannot be completely ruled out.**

Latest Update on the situation is that the stock market price as on 24th September 2008 is Rs.182.75. Thus, though the company is recovering through the bad phase the current global and Indian market conditions have kept the upward progression in check.

Profitability and distress check

	2005	2006	2007
Sales Turnover	3310.7	4550.9	3929.2
Reported Net Profit	461.1	361.8	-1552.1
EBIDTA	785.6	780.4	141.7

Source: http://www.moneycontrol.com/stocks/company_info/yearly_results.php?sc_did=SA10

Year 2007 has been quite disastrous for the company. Following reasons have been identified from its annual accounts (<http://www.stridesarco.com/Docs/Strides%20Annual%20Report%20Final.pdf>):

1. The soft gelatin manufacturing facility in Somerset, New Jersey, USA, owned by it's subsidiary, Strides Inc, USA has been shut down on account of changed regulations

which made the operation of the facility unviable. As a consequence, the Company recognized a permanent impairment in its investment in Strides Inc and a provision has been made in the accounts for a sum of Rs 798.10 Million towards the impairment.

2. The Company exited from the specialty chemicals business, a non-core business, as this was no longer considered operationally viable. Consequently, the Company sold its investment in its wholly owned subsidiary, Sequent Scientific Ltd (formerly known as Strides Research & Specialty Chemicals Limited) for a consideration of Rs.55.20 Million (as approved by the Board) and the resulting loss of Rs.95.30 Million has been accounted as loss on sale of long term investment.
3. (iii) As on December 31, 2007, the Company assessed the value of its investment in its wholly owned subsidiary, Arcolab SA, Switzerland for permanent diminution, if any. Based on such analysis, the Company estimated the permanent diminution in value of investment to the extent of Rs.17.22 Million and has accounted for the same.

However, all the impairment losses and write-offs have now been accounted for and the company has now recovered as evident from its quarterly results observed earlier. Thus, the company is not into distress.

Redemption Burden

As the company is in recovery phase its potential earnings cannot be accurately estimated on the basis of past records. However, as per the Profit & loss Account for the FY 2007-08, Net Cash Profit/Loss can be calculated to judge the current cash flow situation as under:

	Rs.(million)
Profit after Tax	-1552.1
Add: Depreciation/write-offs	188.9
Add: Loss on sale of investments	95.3
Add: Permanent impairment in investments	815.3
Total Cash Profit	-452.6

If all the bonds are redeemed on maturity and not converted before, cash flow on redemption \$40 million bonds at 136.78% and at an exchange rate of \$1=Rs.43.65: Rs.2388.17 million ($\$40 \text{ million} * 136.78\% * 43.65$). Since the company has recently incurred cash losses, such an outflow in near future can be taxing on its financial health. This calls for refinancing the redemption payment.

Promoter holding

As on 30th June 2008, promoters were holding 9.36 million shares which constituted 23.7% of the total shares issued. Total number of shares issued = 40.05 million (<http://money.rediff.com/money/jsp/shareholding.jsp?companyCode=17020557>). If FCCBs are converted then increase in shares = $\$40 \text{ million} * 43.77 / 358.70 = 4.88$ million shares. This thus accounts for more than 10% increase in equity base and promoter holding on conversion would be $9.36 / (40.05 + 4.88) = 20.8\%$. Since, promoter holding is still above 20% after conversion even more than 10% increase in equity base is not detrimental to promoters' management control.

Conclusion and Recommendation

The company is not in distress currently. However, **Kotak SAG can keep an eye over the performance of the company next few quarters to identify entry points (since the company can be vulnerable), if any.** Redemption burden can be huge and thus, an opportunity for Kotak Advisory to step in. However, there is no prepayment possibility and hence **refinancing the redemption is the only viable option as per the current scenario.**

Section 5

Conclusion of overall analysis and Recommendation

Indian Companies have issued FCCBs in bulk in search of cheap finance. Since the year 2003 Indian financial markets and economy both have shown upswing. This has caused a rush in Indian Companies to take good advantage of a Quasi-debt instrument like FCCB. However, the downturn faced by the economies world over, more so US, did not even leave Indian markets

untouched. Since the beginning of the calendar year 2008 the downward movement of financial markets has stunned these companies and put all speculation about further rise in stock prices to rest. For many companies conversion of their FCCBs, with their conversion prices set at a very high premium, has become a distant dream. With rising oil prices and higher inflation the profitability and liquidity of these companies is being affected even further. This has resulted in even so called “sound” companies to book heavy losses. Thus, redemption of FCCBs, which is the only possible event in such circumstances, will lead these companies to go for refinance.

Our analysis above, discards the initial idea of buying out the FCCBs at a discount from the existing holders of the instrument. However, **taking a company perspective provides both SAG and Advisory departments with varied business opportunities from FCCBs.** Our analysis of 9 companies out of the 14 selected above has identified different entry points for the two departments. While SAG has opportunity in two of the companies (Spicejet Ltd. and Subex Ltd) Advisory can have a go at all the companies with an objective of arranging refinance for these companies. However, since existing and future financial condition of each company is different from the other weak links within each company have been identified and analyzed. These links can be used by the Advisory department as an instrument to convince the company management to go for refinance. **Thus, an opportunity (potential of business from FCCBs) which was earlier thought and initiated to serve only Kotak SAG turned out to be more profitable venture for Kotak Advisory Group.**

The techniques and parameters used in the above analysis can also be applied by Kotak to other identified companies, if any. Thus, FCCBs which earlier was thought to be a boon for all the companies might prove to be a curse under certain circumstances (like in sudden economic downturn) which has given bankers and refinancers an additional source of revenue.

Word Count: 18,231

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