Global practices

Dangi welcomes SEBI's moves

On 28 July 2011, the capital market regulator Securities & Exchange Board of India (SEBI) announced new takeover norms for India Inc, more or less conforming to global M&A practices. It has by and large accepted most of the Takeover Regulations Advisory Committee (TRAC) recommendations, which was headed by C. Achuthan.

To start with, one of the accepted recommendations by SEBI is the increase in the initial threshold limit for the acquirer from 15 per cent to 25 per cent of the voting capital of the target company. Considering the initial trigger points in other jurisdiction such as the UK, Singapore, Hong Kong, the European Union and South Africa, where it is 30-35 per cent, the threshold limit of 25 per cent in India is generally acceptable to merchant and investment bankers, in India.

"These trigger levels of 30-35 per cent in other jurisdictions were set primarily based on the level at which a potential acquirer can exercise *de facto* positive control over a company. Thus, taking into account both the ability of promoters to exercise *de facto* control at 25 per cent, and the law governing special resolutions in India, the increase in limit to 25 per cent is a good move", explains Pavan Kumar Vijay, MD, Corporate Professionals Capital.

However, striking a note of caution for promoters with low holding, Vijay points out that this increase in threshold may have a negative impact on promoters who hold 15-25 per cent stakes and were eligible for creeping acquisition of 5 per cent in each financial year as per SEBI (SAST) Regulations 1997. With this new initial trigger point, they can increase their holding to 24.99 per cent of the voting capital of the company. And for becoming eligible for creeping acquisition in terms new takeover regulations, they would be required to give a mandatory open offer to the shareholders of the company.

"The raising of the threshold limit for making a mandatory open offer to 25 per cent is a welcome move, as it is a step closer to the best global practice followed internationally. This will encourage more bids from private equity (PE) investors from other countries for Indian companies," says Lalit Dangi, chairman, Libord group.

"Currently, there are many companies wherein the PE players limit their holding to 14.9 per cent stake in order to avoid the open offer. However, after the proposed changes, such players will get much more headroom to increase their shareholding to 24.99 per cent without going for mandatory takeover open offer. Also, it would act as a catalyst to the fund-raising plans of the India Inc," observes Saumil Shah, ED, M&A (Tax), KPMG.

"The absolute level of holding of 25 per cent is good enough to give protection to the PE investor (given that 26 per cent of those present and voting is enough to block special resolutions) rather than merely relying on a shareholder agreement," explains Gautam Jain, deputy head, investment banking & advisory, Enam Securities.

International norms

Another important move by SEBI is with respect to the open offer portion which has been increased from 20 per cent to 26 per cent of the voting rights, rejecting the recommendation of the Achuthan committee, which was for a 100 per cent offer size. Here, the Indian takeover law is in contrast with the rules prevalent in the other jurisdictions, such as the UK, Indonesia, Japan and France, where the open offer is pegged at 100 per cent. "Following the international norms for open offer for the residual shareholding would have put unnecessary financial burden on the acquirer," says Sudip Bandyopadhyay, MD & CEO, Destimoney Securities.

In India, the limit to 26 per cent will put the minority (public shareholders) under a precarious situation, since complete exit is not available to them vis-a-vis the promoters of the target company. "The TRAC had proposed such an amendment, since this could result in the increase in the cost of financing the acquisition and also act as a deterrent to the domestic acquirers, this proposal by TRAC was not implemented," feels Shah of KPMG.

"Making 100 per cent offer size is more equitable to minority shareholders, giving them an opportunity to fully tender their shareholding. However, one needs to keep in mind also the ability of the Indian acquirers to raise the resources necessary for a 100 per cent buyout in the context of restrictions on Indian banks to fund share purchases and the existence of an under-developed debt market," says D.R. Dogra, MD & CEO,

Credit Analysis & Research.

"The minimum offer size at 26 per cent seems to be an Indianised version of global norms. In the context of borrowing challenges that Indian acquirers currently face for acquisitions, the increase in offer size, in the form of a 'baby step' of 6 per cent, indicates SEBI's intent of converging with global norms in a time-bound manner," opines Jain of Enam Securities.

SEBI in its new code has decided to retain the existing definition of control, as given in the SEBI (SAST) Regulations, 1997. "However, the term 'negative control' has not been defined and has been variably used by the SEBI in its judgment," points out Vijay. For instance, in the matter of acquisition of shares Daikaffil Chemicals India, SEBI denied the exemption to the acquirer on the ground that, with the acquisition of 25.10 per cent shares in the company, the acquirer will exercise negative control over the company in the form of stopping the special resolution. Thus, the term 'negative control' as used by SEBI in its various judgments and exemptions orders needs to be specifically defined under the regulations.

'Control' has lacked a strong and clear definition in the Indian context. "The definition in the existing regulations is complex to understand and cumbersome to implement. The new code has not resolved this issue. Also, the interim period management of a company needs greater clarity and protection from a continuing shareholder standpoint – there is currently a long gap between when a change in control event occurs (friendly or otherwise) and by when an acquirer comes into control (add time required for Competition Commission Approval)", adds Jain.

In terms of pricing of an offer, the present regulations allow for the payment of non-compete fees up to 25 per cent of the offer price to the erstwhile promoter, without including it in the offer price. Here, SEBI has accepted the recommendations of the Achuthan Committee with respect to the outright scrapping of non-compete fees and inclusion of any amount paid as non-compete fees or control premium in the offer price to be paid to the shareholders of the target company.

SANJAY BORADE

Dogra feels funding is an issue

This scrapping of non-compete fees is highly debatable. Some management experts believe that there is a difference between the general shareholders and the persons who manage the affairs of the company. There can be hundred heads in a company (such as the general shareholders) but there will be only one mind (one managing the company). "Thus, it would not be justified if they (promoters) are not paid the additional amount for the efforts made by them to run the company," explains Vijay.

Cast an obligation

"The abolition of the non-compete fees will ensure uniformity in treatment between the promoters and public shareholders. Earlier, this had resulted in discrimination between the promoter shareholder and other public shareholders. Also, there were disputes between the regulator and the parties on this issue," points out Shah of KPMG. "Removal of no-compete fees makes the takeover process transparent and fair for the minority shareholders. This has removed a major grey area," concurs Bandyopadhyay.

Interestingly, the new regulations has cast an obligation on the board of the target company to constitute a board of independent directors, which will provide its reasoned written recommendations on the open offer to the public shareholders of the target company. "Currently, company boards in India leave it to shareholders to take a call on which bid to accept. Globally, company boards have a fiduciary responsibility to objectively consider open offers. Shareholders benefit because they get guidance on the offer that is in the best interests of the company, which would tell them whether to tender the shares in the offer or to continue with the new management," observes Dangi.

This recommendation is a positive move, as long as the independent directors remain truly unbiased. But, there is still much confusion in this new provision. The Achuthan committee report has not provided any criteria on the basis of which the board has to give its recommendations to the shareholders. It has to be seen whether the new takeover regulations, which are yet to be notified by SEBI, provides such criteria or not.

Today, with the new guidelines in place and ready to come into force, promoters will be on the alert. The M&A landscape in India is set to change, hopefully for the better, and should witness increased activity. "Given that the stock market is quite placid and is expected to remain so during the course of the year, given the state of the economy, these regulations will help companies attract investors and can prove to be game-changers," adds Dogra.

The new regulations indicate a balanced approach with two central pillars – protection of minority shareholder interest (scrapping of non-compete, mandatory recommendation by the board to minority shareholders) and alignment with global practices in a phased manner. This represents a landmark step in putting several ingredients in place to change the Indian M&A landscape.

The era of hostile takeovers has already arrived in India and is likely to intensify. Takeovers are market's way of disciplining management in as much as the bidders are perceived to be better in management than the embedded ones. The better of the two are likely to be supported by other shareholders, especially institutional investors.

• LANCELOT JOSEPH