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‘Barbarians at the gate’

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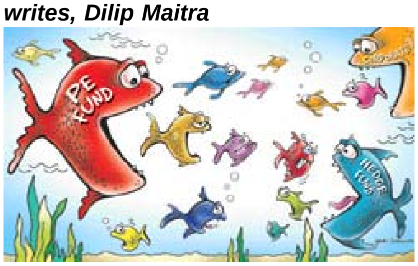
Proposed changes in the takeover code may make Indian companies open to hostile acquisitions, but modifications were much needed writes, Dilip Maitra



In 1990, when the giant private equity fund KKR (Kohlberg Kravis Roberts & Co) raided and acquired the American biscuit company RJR Nabisco Corp in a $25 billion leveraged buyout (LBO), the tussle between RJR and KKR was documented in an aptly titled book ‘Barbarians At The Gate’ written by financial journalist Bryan Burrough.

Now in India we may soon come across situations where many corporate chiefs will complain about ‘Barbarians’ at their gates because India’s merger and acquisition (M&A) rules are all set for a complete makeover from April 2011. The rules will become simpler, more transparent and free from many roadblocks that now come in the way of M&A. The M&A activities in our country are regulated by the Takeover Code laid out by the capital market regulator Securities and Exchange Board of India (Sebi). To overhaul the 15-year old takeover rules, last week a Sebi-appointed committee, Takeover Regulations Advisory Committee, headed by C Achuthan, proposed sweeping changes in many important issues like open offer trigger, offer size, pricing norms, non-compete fees, etc. Changes proposed by the Achuthan committee are now open for public debate and, if accepted, will become the new Takeover Code from the next financial year.

The real threat

In a major change, the Achuthan committee suggested that the trigger point for a mandatory open offer should be raised to 25 per cent of the equity capital. Earlier, an acquirer needed to make the open offer to buy shares the moment his stake reached 15 per cent. It also suggested that the mandatory open offer should be for the entire 100 per cent of the equity capital as oppose 20 per cent under the present norm.

The twin changes, if incorporated in the takeover code, will make it easier for a predator to swoop down on an Indian company in which a promoter has less than 50 per cent stake. According to a study done by SMC Capitals, of the 500 companies in the ‘BSE 500’ list, promoters own less than half the equity stake in as many as 215 companies making them prime targets for takeover. The 100 per cent mandatory open offer may now help an acquirer to gather more than 50 per cent share in a company and takeover the management. If the acquirer’s stake reaches up to 90 per cent, he can even get the company de-listed from the stock market.

Said SMC Capitals Limited Equity Head, Jagannadham Thunuguntla, “With this revision, we may witness a new era of takeovers in India. If promoters co-operate, takeovers will be friendly. Otherwise, the they can be hostile. Either way, the stage is all set for a new regime of takeovers in India.”

Out of the 215 companies vulnerable for takeover, single shareholders own between 10 and 49.99 per cent in the case of 76 companies. This means in case of these companies there are already big investors who are not with the promoter and they can strike quickly if they decide to. “This is especially true considering the fact that the new guidelines have permitted the seamless integration between open offers and de-listings, ” Thunuguntla said.

Some of the major companies ripe for hostile takeover according to SMC’s listing are as follows: Moser Baer — promoter holding is 16.29 per cent and the largest shareholder Warburg Pincus is holding 13.10 per cent; Apollo Hospitals — promoter 33.54 per cent and investor Apax partners 13.80 per cent; India Cements — promoter 25.18 per cent, investors LIC 13.44 per cent and HSBC 12.10 per cent; Polaris software — promoter 29.08 per cent and investor 26.98 per cent; Indiabulls Securities — promoter 29.88 per cent and investor HSBC Global 14.84 per cent.

In all these cases if the investors with large holdings decide to be aggressive and make a bid for 100 per cent of the company, it can be a serious threat to the existing promoters. The market also seems to have got the wind of the impending threats as the buying activity has peaked in shares of companies with low promoter holdings. Sesa Goa, East India Hotels, Petronet LNG, Syndicate Bank, Gati etc, are companies where large number of shares have changed hands, thus pushing up their prices.

Promoters’ protection

To protect themselves from a predator, weak promoters will have to work harder in the future. First of all, many will start buying shares of their own companies to take the holding up to at least 51 per cent. Under the creeping acquisition norm, if their acquisition crosses 5 per cent of the equity in a year it will trigger a mandatory open offer. A promoter can also make a voluntary open offer to thwart a hostile bid, but in such a case, one can buy only 75 per cent of the equity and not 100 per cent. The possibilities of bids and counter bids will certainly make acquisitions more competitive and expensive after the new code comes into effect. Though terming the recommendations as fair and pro- investor, Ernst & Young National Leader Global Financial Services Ashvin Parekh said, “M&A deals may become expensive if the proposal comes into effect due to proposed changes in the offer price calculation.”

However, some experts say that costlier M&As will bring only serious players into the space. “This code will bring in only serious players into the M&A space as the cost of acquisition will be higher,” said Nishith Desai Associates Principal Siddharth Shah. We may also see many leveraged buyouts (LBOs) in future as banks and investors will be willing to fund hostile takeovers. Thunuguntla thinks that in the LBO game the possibility of takeover bids is higher from the foreign acquirers because the they have larger financial muscle and access to the several modes of funding options.

Good for investors

The proposed changes in the Takeover Code, however, will be good for large institutional investors and for private equity (PE) funds because they will be able to buy shares up to 24.99 per cent without making an open offer. For example, the Life Insurance Corporation (LIC), which collects thousands of crores from insurance policies sold to individuals, invests in shares of blue chip companies to generate returns. LIC wanted to raise its holdings beyond 14.99 per cent in many good companies but the deterrent was the open offer trigger at 15 per cent.

Now both insurance companies and mutual funds will be able to build their equity portfolio up to 24.99 per cent without triggering the open offer. Investors in these financial institutions should thus be the ultimate beneficiaries.

Even the private equity investors who normally buy stakes in companies after negotiating with the promoters, will benefit. Since this class of investor is not interested in running a company, their exposures were restricted to 14.99 per cent to avoid open offer. Soon they will be able to invest up to 24.99 per cent. Said Deloitte India Leader (Financial Advisory) Avinash Gupta, “The proposals are positive news for private equity investors. If approved, they will provide flexibility to PE investors and give leeway for making more deals happen in the Indian corporate space.” Larger participation from PE players is also good for corporates interested in raising funds through the equity route without going through the hassles of public issue of shares.

Wide ramifications

The recommendation to make the mandatory open offer for 100 per cent of the equity will also benefit all classes of investors in a company. In the present system where open offer is needed only for 20 per cent, the unlucky ones get stuck.

Now, everybody — be it mutual funds, banks, PEs or individual shareholders— will have equal opportunity to sell and get out of a company. Another positive suggestion is that if an acquirer pays non-compete fee to a promoter at the time of acquiring his stake, the same must be factored in the open offer price for all. These two norms will bring in a great deal of equality among the shareholders of a company, though promoters and the acquirers may not like it.

Nuisance value

Though the suggested changes in the takeover code will favour acquirers and the non-promoter shareholders, Sebi must bring in certain degree of checks to make sure the takeover bids are not frivolous and meant only to create problems for the existing promoters. It is now possible for an investor with deep pockets to build up a large stake in of up to 24.99 per cent a company at a low cost when its share price is languishing due to a variety of reasons. Such a stake can be a hawked later to interested rival companies at a huge profit.

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