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Boom-era quick-fund deals turn sour for cos

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AWAY from the media glare, many Indian companies are in the midst of bitter negotiations with foreign private equity investors and hedge funds, which had put money in these firms in the hope of making a killing. These investors came in droves around 2006 and early 2007, buying an instrument called cumulative convertible preference shares (CCPs), which the Indian companies, mostly unlisted, had issued to get quick money and side-step regulations on foreign investment.

Billions of dollars changed hands at boom-era valuations, as local firms promised the investors an easy exit through the stock market. The deal was simple: CCPs had a tenure of three years, offered a fixed interest, and at the end of three years, could either be redeemed to pay back investors or be converted into shares, which could be sold once the company got listed.

The three-year period is now coming to an end and Indian promoters neither have the money to pay overseas investors nor the will to enter a dormant IPO market. Senior bankers told ETthat close to $5 billion of CCPs are maturing this year. The instruments will either be converted into shares of the local company or redeemed, depending on what was agreed upon. Some think the number could be higher. These deals are not in the public domain and are rarely tracked by institutions, which compile investment data. But, according to investment banking circles, at least $10 billion had entered the country through this route till June 2007, when a government notification changed the rules of the game.

Today, with many of these unlisted firms defaulting on the interest payment on CCPs and failing to fulfil conditions like floating an IPO or sticking to a pre-agreed business plan, the foreign funds are demanding their pound of flesh. Finding their money stuck, some investors are preparing to begin arbitration proceedings in offshore locations like Singapore, while a few are pushing Indian promoters to relinquish control on firms.

"In a situation of financial crisis, investors are looking at profitable exits as agreed upon either through an IPO or trade sale, which the investee companies are unable to provide, leading to a mismatch of expectations and disputes. Consequently, in some cases, parties are resorting to remedies available in cases of dispute, while some are looking at various options for restructuring their investments," said Vyapak Desai, who leads a litigation and dispute resolution practice at the law firm Nishith Desai Associates.

Foreign investors may get higher stakes in local cos

THE firm is advising several investors and a few Indian companies in such cases. Mr Desai, who refused to name the parties owing to client confidentiality, said there are Indian firms across industries like real estate and retail besides other sectors in which serious differences have cropped up between the promoters and financial investors. In many

cases, the investors may end up getting a higher stake through a better conversion ratio or extract veto powers on key decisions in future.

According to Vivek Gupta, partner at the transaction services firm BMR Advisors, "The reality is that issuers in most cases don't have the cash to redeem, while the conversions were agreed on bull market valuations. Therefore, I expect there will be a series of rollovers and/or renegotiations. And since the instruments are in most cases preference shares, investors have a challenge in terms of being able to directly enforce lender rights."

Added Mr Gupta, who leads the M&A practice in BMR, "Many convertibles are coming up for either redemption or conversion. It's very difficult to put an exact number on the amount."

The CCPs were structured in such a way that pure debt could masquerade as equity; this was important since the money came in through the hassle-free route of automatic foreign direct investment (FDI).

Even though these instruments had the intrinsic quality of debt, they were termed 'shares' to pass FDI muster. Classifying the investments as 'debt' or 'borrowings' would have raised the hurdles that are associated with external commercial borrowings (ECBs) — something that Indian companies wanted to avoid.

After June 2007, the rules were tightened to ensure that CCPs get compulsorily converted into shares, failing which they were classified as debt. This was done to stop the unbridled flow of overseas arbitrage money — where foreign funds borrowed abroad to invest in India — that was fuelling asset bubbles in markets like properties. But soon, Indian companies, starved of domestic institutional finance, found a way out to beat the rule.

The fresh investments that were structured after June 2007 gave a put option to the foreign investors who could exercise it to sell the securities back to the promoter after three years. Here, the onus was on the 'promoter' to buy back the security since the company (post-June 2007) had to convert these into shares. This new instrument, tagged with a put option, was used till late 2007 and even early 2008 to bring in foreign investment.

The total FDI through these routes could have crossed $15 billion before the market crashed. In the next one-and-half years, many more such papers will come up for conversion and in several cases, the investors will invoke the put option. If the IPO market fails to revive and the foreign investors don't get an exit, these fancy deals could be the trigger for hundreds of disputes between closely-held Indian firms and foreign investors.

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