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Debt-listing of convertible pref shares may hurt to the core

Apart from reducing fund flows to real estate and infrastructure, the move will also hit distressed asset funds, finds Shishir Prasad

THE demise of the optionally convertible preference share (debt pretending to be equity) will not only choke off funds to the real estate sector, but will hit another class of investors: the distressed asset funds. Besides, investors specialising in infrastructure — a priority area for the government — and unlisted companies will also take a hit.

Conventional private equity guys, in reality, will remain unscathed because only 15-20% of all private equity investments are done through the convertible route. CMIE data (for listed companies) for the last two years on convertible preference share shows just 21 transactions. In any case, more than the classic private equity firms, it was the distressed asset funds that used the convertibles to their advantage.

Distressed asset funds have been the pioneers in using convertibles to invest in companies that are in poor financial conditions. They had good reasons to do so. In 2002, when banks were reeling under the weight of loans extended to companies in shaky financial health, the government stepped in. They brought in a regulation that allowed banks to take control of such troubled firms. It also created a specialised company (Arcil) that would take charge of these companies and sell them to investors who would then turn around the company.

Investing in such companies' equity was fraught with risk because if the company did not return to good health then the entire investment was lost. To mitigate the risk, funds like Asia Debt Management, Citadel, Spinnaker, Clearwater and Stark Investments, and of late, Goldman Special Situations Fund, used the optionally-convertible route.

The convertible, in the initial phase of the turnaround, paid interest at 15-16% on a regular basis, to the fund. If the turnaround took place, then these funds turned the convertible into equity. If the company floundered, then the interest at least recovered some part of the investment. Asia Debt Management (ADM) used the convertible to invest in India Cements. Clearwater Capital invested in Kopran, Citadel invested in Aban Lloyd. According to sources, Deutsche Bank invested in Sanghi Cements and PVP Ventures in the same way. The Sanghi Investment was later sold to ADM and Spinnaker. "For large deals, the convertible preference offered a lot flexibility," says Ruetveij Pandya, Associate, Nishith Desai, a law firm.

Now that the convertible will be treated as external debt, the maximum interest that a company can pay to the fund is just 8-9%. That's too less a risk for picking up distressed assets. Also, going to be hit are unlisted companies. Investing in unlisted company, especially if it does not make it to the public market has forced firms in the past to use the convertible. Apart from them, infrastructure companies found the convertible a useful route to increase the amount of debt that they could take on their books.

Since the convertible acted as a debt, it allowed the company to put up less equity and that boosted the return on the projects. So for example, if a road project needed Rs 10 crore in equity and Rs 20 crore in debt. The company could bring in another Rs 5 crore as promoter's capital, another Rs 5 crore in the form of convertible which would count as equity capital and then bring in Rs 20 crore as debt. Once the project was over, the convertible would simply be paid out without turning into equity and all the return would then be calculated on Rs 5 crore capital (instead Rs 10 crore otherwise) and that would boost the returns on the project and attract more investors.

Now with that route being closed, many PE firms said they would really have to think twice before they put money into an unlisted entity. But, not everyone is so sure. Sanjeev Krishan, who leads the M&A and PE team at PriceWaterhouseCoopers, says that this will force many firms to become more prudent before they invest.

"Once they do, they will take the risk as is their mandate, rather than focus on approaching the company from a lender's mindset," he says. Any which way one looks at it, the move of taking away the flexibility offered by the convertible will, in all probability, offer only minor relief to the government, if the capital inflows to the stock markets continue like before.

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LOSING CHARM

Distressed asset funds use convertibles to invest in companies that are fiscally unfit
Such funds used the optionallyconvertible route to mitigate risks
Listing of convertibles as debt will cap interest payable to funds at 8-9%