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PEs might have to give up rights in listed firms

Experts say terms on IRR, board seats & anti-dilution unsustainable

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Private equity players might be forced to dilute shareholder agreements (SHAs) with listed firms and their promoters, following a backlash from minority investors.

Private equity (PE) funds might have to restrict their rights to protection of interests and stop short of stepping into the shoes of the management, following a closer scrutiny of these SHAs by investor advisory firms and regulators.

The issue came to the fore last week when Institutional Investors Advisory Services, a proxy advisory firm, asked minority investors to vote against a proposal by gold loan firm Manappuram Finance to grant some special rights to a set of private equity investors.

SAFEGUARDING INTERESTS
Some rights opposed by small investors

- Adjustments upon issuance of additional equity shares
- Adjustments for reclassification, exchange and substitution
- Preference to specific investors on the occurrence of a liquidation
- Right to appoint nominee director
- Anti-dilution
- Right of first offer
- Right of first sale
- Tag along rights

Source: IIAS

In a classical private equity sense, such shareholder agreements made perfect sense. In the absence of a proper investor protection framework, it was up to the PEs to ensure their investments were protected through the SHAs.

Nimesh Salot, director, Ladderup Corporate Advisory, said: “For an unlisted or privately held company, the special rights make sense and investors always demand for these. The principle behind such rights is to protect the investment, including the entry valuation, and inculcate corporate governance practices. Also, such investments are considered to be active investments, wherein the investor plays an active role on the strategic front.”

However, in private investments in public equity (PIPE) deals — the industry term for listed space investments — these rights come into direct conflict with the investor protection framework laid down by the Securities and Exchange Board of India (Sebi), which include the listing deal and takeover regulations. Sebi has routinely asked PE-backed companies that come for listing to scrap these shareholder agreements ahead of listing. After listing, the monitoring is not that active.

Saurabh Agarwal, director, Kennis Group, said: “Even in PIPE deals, PEs try to get the promoter to commit to a specific IRR (internal rate of return). While the promoter has no obligation to commit, it depends on who is more desperate — the promoter or the investor.” If promoters are keen to get PEs on board, they are willing to yield more rights, often at the expense of the smaller investors.

“PEs’ appetite is big. Therefore, they are taking a big risk,” said Agarwal of Kennis. “They should not make it an excuse to get some extra rights. For example, if there is a representative board member, he comes to know of the quarterly results in advance. How do you justify this? PEs should also come to know only when the results are officially published.”

Lawyers say it is not easy to convince Sebi to allow some directors to continue on the board when a PE-backed firm comes for listing. But on some occasions, the regulator had allowed directors nominated by PE firms to continue on the board after listing.

While under the listing agreement the company is barred from conferring a superior right to vote or dividend on any particular investor, the takeover code requires acquirers of ‘control’ to offer an exit option to minority investors.

Some rights certainly affect small investor rights, say experts. “Take, for example, anti-dilution rights. In a hypothetical situation, a company has to infuse further capital and that has come at a valuation which is lower than that offered by the earlier investor. In such circumstances, the investor would get additional shares at zero value or nominal value in such a manner that the entry valuation for the investor gets adjusted. Such a right would be impossible to be allowed in case of a listed entity,” said Salot of Ladderup.

Ruchi Biyani, Nishith Desai Associates, said, “In most PIPE deals, PEs will always want to have some minimal rights. Otherwise how do they protect their investments? But when these rights get into the area of day-to-day management of affairs such as marketing plans, budgets and key managerial personnel, they become little dicey.”

According to Biyani, funds should water down the provisions to the extent they don’t infringe upon the management and strike a balance. Agarwal said it would be better if PEs take the lead and do it themselves rather than being forced by others, including regulators.