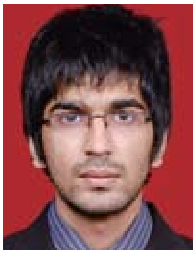
Private equity investors face an exit conundrum

By Siddharth Hariani and Hemant Krishna V, Phoenix Legal



PHOENIX LEGAL

New Delhi
Second Floor,
254, Okhla Industrial Estate,
Phase III, New Delhi-110020
India
Tel +91 11 4983 0000
Fax: +91 11 4983 0099
Email: delhi@phoenixlegal.in

Mumbai
First Floor, CS-242,
Mathuradas Mill Compound,
NM Joshi Marg, Lower Parel
Mumbai - 400 013, India
Tel: +91 22 4340 8500
Fax: +91 22 4340 8501
Email: mumbai@phoenixlegal.in

Foreign private equity investments have made a considerable contribution to India's economic growth. Through their role of providing "enabling capital" – funds injected into a company at a critical juncture – private equity investors often facilitate the development of a company's product line, finance its capital expenditure, boost its scale of operations and aid the diversification of its business activity.

These investors do not come into a company to take control of it. A typical private equity fund would prefer to have a predetermined timeline, generally three to five years, for exiting the company with a return on its investment.

Within this time, the fund attempts to add value to the company and help it realize its true potential. A private equity investor, therefore, commonly aims for a timely exit with a handsome return on its investment.

Mapping an exit

The exit mechanism often takes centre-stage during the process of negotiating the transactional structure of a private equity investment. Of late, certain exit routes, not uncommon in private equity investment agreements, have come under a cloud due to changes in India's legal landscape.

With exits becoming trickier, many innovative exit strategies and structures are being chalked out at the negotiating tables. The prevalent exit routes which enjoy wide currency in India include merger and acquisition, listing of the company by way of an initial public offer, buyback by the company, drag along of the promoter's shares along with investor's shares, and a put option on the shares bought by the investor.

A put option is often the last resort of the investor and implies an obligation on the company or on the promoters to purchase the investor's stake for a pre-agreed minimum price upon the investor exercising the option. As the changed economic scenario means that achieving an IPO or a merger and acquisition is no easy task, investors are left with no option but to exercise the put options and as no promoters would be happy to pay up from their private coffers, it needs to be enforced.

Clouds over options

However, the put option seems to have fallen out of regulatory favour. Recent reports suggest that the Reserve Bank of India (RBI) has adopted the stance that fixed price exits through put options are in the nature of debt and not equity. The simple reason being offered is that a pre-agreed buyback guaranteed by the promoters does not carry an equity risk. The consequence of this reclassification is that the enforceability of put option clauses is now questionable.

The securities market watchdog, the Securities and Exchange Board of India (SEBI), has also recently opposed agreements with put and call options, which they hold as illegal and invalid under the Securities Contracts (Regulation) Act, 1956. According to SEBI, put options do not qualify as a spot delivery contract as they are exercisable on a future date. Further, they would not qualify as a derivative contract as it is a private arrangement and is not traded and settled on a public bourse.

This view apparently taken by SEBI in its directive in the Cairn-Vedanta matter created a stir in the business community. Subsequently, SEBI reasserted this view in an informal guidance to Vulcan Engineering Limited.

Trying times ahead

In the West, private equity investors have gained notoriety for having the power to ride roughshod over companies which fail to meet their performance expectations. In numerous instances, they have been charged with trampling over the assets of companies to recover their targeted returns on investment, while leaving companies in debt.

In India, however, the modus operandi of investor exit has been tethered to a different reality. While the positions taken by the RBI and SEBI are likely to be dragged under the judicial scanner sooner than later, for the time being the regulators have definitely set the alarm bells ringing for private equity investors sitting pretty on put options.

The immediate fallout of this is likely to be that private equity investors will be reluctant to put all their eggs in one basket and will instead drive a hard bargain for a bundle of exit rights so that when the time comes for them to depart, they don't find their exits sealed off by the regulators.

There is a joke doing the rounds in investment camps: "How can you tell the private equity delegates in a business conference? They always sit close to the exit." Now they may have to gear up for a run-in with the regulators at the exit.

Siddharth Hariani is a partner at the Mumbai office of Phoenix Legal, where Hemant Krishna V is an associate. They can be reached at siddharth.hariani@phoenixlegal.in and hemant.krishna@phoenixlegal.in