Closed boardrooms discourage investors

By Priti Suri and Priyatha Rao, PSA Legal Counsellors


E 601, Gauri Sadan
5, Hailey Road
New Delhi, 110 001
India
Tel: +91 11 4350 0500
Fax: +91 11 4350 0502
Email: p.suri@psalegal.com

To say that India is an attractive investment destination is clichéd as it is quite evident that business prospects have increased by leaps and bounds over the past decade.

The most recent push towards India has been by private equity ("PE") investors, who have been scouting for budding entrepreneurs and mid-size companies for investment purposes and acting as a catalyst for many such entrepreneurs and companies looking for a quick and firm footing in business.

Seeking targets

Typically, PE investors seek to invest in businesses with a promising future and select the target companies on the basis of several factors such as market potential, growth opportunity, long-term sustainability, exit opportunities, and participation in management, which is attractive for those who want to direct a shift in the functioning and style of the investee company.

However, in India, making inroads into the boardroom is often easier said than done.

This column discusses management issues and the reasons for the impediments faced by PE investors to becoming actively involved in management or asserting control over the Indian investee companies.

Management control

A company has two main organs, the body of shareholders and the board of directors.

The latter is the managerial body.

Sections 291 and 292 of the Companies Act, 1956, stipulate the general and special powers of the board respectively.

It is evident from section 292 that certain matters like borrowing money, investing the funds of the company, loans, etc, can be decided only by the board by means of a resolution.

Hence, the composition of the board becomes an important factor, especially for PE investors eager to acquire a stake in a company.

The general course followed by PE investors upon acquiring a stake in the investee company, is to restructure the organization, make it profitable and subsequently exit with good returns.

The restructuring often entails a change or dilution in the management of the investee company.

Herein, the PE investors place their representative(s) in the management (i.e. the board) of the investee company. But all too often they face resistance from the existing promoters, shareholders and directors.

Family affairs

This is because in India, closely held private companies are primarily family-run businesses and, thus, the management is tightly controlled and deeply centralized.

The general tendency is to keep the business within the confines of the family and not allow "outsiders" into the boardroom.

Therefore, once the glamour of the investment wears off and the PE investors attempt to co-manage and exercise control, it is not well received by the existing members who perceive such attempts at change as intrusive. This in turn causes friction.

Conflicting approaches

Business needs may necessitate spinning off a part of the acquired business. This requires a consensus vote from the board members.

However, the existing members may be against the move and reject the proposal, which eventually impacts growth.

As most PE investors want active management participation, the unwillingness of some enterprises to permit this has resulted in several unsuccessful deals in India.

A recent example is the apparent fallout between PE players Apax Partners and Blackstone and the Mumbai-based software company Patni Computers.

The fallout revolved around a difference of opinion between the PE groups and the promoters over the management and control of the target company.

The PE players were purportedly against the idea of allowing the brothers that controlled Patni Computers on the board, as they feared unwanted intervention from the brothers in the decision making process.

Active participation

In short, although PE investment has come a long way in India, the ride is still rough.

The freedom to assert active participation in the management of the investee companies is one of the fundamental concerns of investors which must be covered extensively in the investment contract before the deal goes forward.

Unless there is flexibility and a change in the Indian corporate mindset, the chances are that many investee companies might miss out on some good funding opportunities.

Priti Suri is the proprietor of PSA. Priyatha Rao is an associate at PSA.