

Private Equity Acquisitions: Securing Investment Through Preference Shares

The private equity sector is thriving in India and looks only set to grow as more investors seek to take advantage of the huge potential returns offered by a rapidly expanding market. Once the market matures, however, turning a profit will depend largely on the structure of the investment. As a result, acquirers and investors should bear several key points in mind when structuring a venture.



By Priti Suri
PSA, Legal Counsellors

Private Equity has seen a spurt in growth over the past few years in India. If statistics are to be believed, private equity firms in India have invested nearly US\$1.98 billion during the quarter ending September 30 2006 – 2.8 times the investment made during the same period last year. Success stories abound, notably the exit of Warburg Pincus from Bharti Televentures. After an original investment of US\$300 million, within about five years, the firm was able to realize almost five times its investment through the sale of its shares in tranches on the stock market over a period of time and conclude its sale to a strategic investor, Vodafone, in 2005. In another notable deal, Citigroup sold its 23% stake in Progeon, a business process outsourcing entity, to Infosys Technologies for US\$115 million.

Given the potential lucrative returns, private equity acquirers and investors want to ride the wave and realize early profits. Although the private equity market in India is still evolving and companies are able to get high returns in this bullish environment, once the market matures and crystallizes, these profitable exits will largely depend on investment structures. It therefore becomes imperative to understand how the dynamics of such investments work and what a PE acquirer or investor should bear in mind while structuring a transaction in India.

In its literal sense, private equity refers to the private placement of

shares by companies that have not gone public or companies that have not listed their stocks on public stock exchanges. The funds raised through private equity are essentially used to develop new products and technologies, expand working capital, for acquisitions, or to strengthen a company's balance sheet. In contrast, venture capitalists provide money to startup firms and small businesses lacking access to capital markets but that are perceived to have long-term growth potential. A venture capital investment typically entails high risk for the investor but has the potential for above-average returns.

Private equity investors face many unique challenges. As private equity cannot be easily converted into cash because the stocks are not traded on the stock exchange, securing and structuring a timely exit becomes crucial. In the absence of a designated marketplace, an acquirer or investor wishing to sell securities in private companies must find a buyer, and there are many transfer restrictions on the securities

of Indian private limited companies.

The types of equities that can be issued by Indian companies are enumerated under provisions of the *Companies Act, 1956*. In any acquisition or direct investment, it is essential that a private equity player secures investment in terms of returns, profitability, liquidation and exiting a company at the right point in time. There are limitations and advantages to certain securities and many aspects that a private equity acquirer or investor and the target company should consider.

Types of Issued Share Capital

A company may have two kinds of share capital, equity or preferential. As per Section 85 of the *Companies Act*, preferential shares are those shares that get preferential treatment as compared to equity shares. This preferential treatment includes a fixed rate of dividend and, upon the winding up of the company, a preferential right to be repaid the amount of capital.

Further, preference shares may be cumulative or non-cumulative regarding payment of the dividend, which can only be made out of the profits of the company. In the case of cumulative preference shares, the unpaid dividend gets accumulated and is carried forward to the next financial year. For non-cumulative preference shares, if the company has insufficient profits and is unable to declare a

dividend, then such dividend lapses and there are no arrears in the company's accounts.

A private equity acquirer or investor ought to consider not only possible returns but also securing the investment in the case of company liquidation. Both these eventualities are aptly covered by preference shares, but while they provide the security of a return on investment and preferential treatment at the time of liquidation, such shares carry only limited voting rights. If an investor wants the right of active management participation in the decision-making and implementation processes of the company, agreements have to be drafted craftily.

Voting Preferences and Limitations

Voting rights delegated to shareholders based on the equity they hold are governed by Section 87 of the Act, which states that every member (shareholder) of a company limited by shares and holding equity shares has a right to vote on every resolution. However, in the case of a poll, voting rights are delegated proportionately to the paid-up equity of each shareholder.

The voting privileges of a preference shareholder are curtailed to a large extent, i.e., the holder of preference shares can only vote on resolutions that directly affect the rights attached to his shares. These voting limitations, however, do not apply when a preferential shareholder, holding cumulative preference shares, is not paid dividends for an aggregate period of two years or, for non-cumulative preference shares, is not paid for the two preceding financial years or three out of the last six years. In such cases, the shareholder derives a right to vote on every resolution.

Structuring Indian Investment

Traditionally, Indian companies are family-owned enterprises, driven by the decisions of family members as opposed to professional managers. Thus, an investor must wager on the wisdom of the individuals running the show, rather than on the enterprise as a whole. Private equity acquirers and investors have started imposing stringent terms on contracts as a result in order to safeguard their potential economic returns.

Such terms are typically harsh on the existing shareholders and the management, including the promoters and key employees. Nevertheless, capital-starved companies, or shareholders willing to cash out on their equity, are left with little choice but to surrender to certain key terms. These terms are aimed at preserving the investor's economic interest in the company and, typically, include lowering the valuation of the assets so that the investor pays less into the company initially or when cashing out at the expense of the existing shareholders.

As highlighted above, preferential shares are better options for investment. Such shares have to be redeemed by the company either by paying off the full amount to the shareholders or by issuing equity shares within 20 years from the date of issue. When executing an agreement that mandates either the allotment or transfer of preference shares, the time and mode of redemption should be clearly spelled out. The contract may include the stipulation that the preference shares will be redeemed in cash or a conversion to equity at the option of the shareholder, provided the terms of issue allow for this option.

Say in Management

Private equity acquirers and investors used to be perceived as those willing to infuse capital into a company who were merely interested in getting their money's worth a few years down the line. This is no longer always the case, as increasingly they want active management participation on the board of directors of the target company. Decisions of the board are made by majority in India. If the acquirers or investors are unable to secure majority representation on the board, they often identify which decisions require their affirmative vote, incorporate them into the agreement and insist that the articles of association of the company be modified to include these matters so as to bind the company. However, both the acquirer/investor and the target company should recognize that granting rights to preferential shareholders contrary to law in the charter documents is pointless, as these rights are unenforceable against the company insofar as they contradict the *Companies Act*.

Full Ratchet Anti-Dilution Adjustments

The full ratchet anti-dilution adjustments clause is incorporated in order to secure any future issue of shares at a lower price, which may lead to a dilution of the existing equity and a decline in the existing value of the shares. In the event the company allots additional shares in future at a price lower than the price paid by the investor, this process calls for an adjustment of the differential amount to be made, which is ascertained by lowering the conversion price of the equity so that the acquirer or investor is entitled to more shares upon conversion. For example, if an investor has paid a price of US\$100 per share at the time of making the investment and subsequently the shares are allotted at US\$70 to the other shareholders, then the adjustment of US\$30 has to be made in favor of the acquirer/investor by compensating him either monetarily or by giving him bonus shares.

A concept that is increasingly used for price adjustment or anti-dilution purposes is known as full ratchet, which requires the company to adjust the shares purchased to equal the number of shares the investor would have been issued, had the investor purchased the shares at the subsequent lower price. This type of

provision can cause a substantial dilution of the equity of existing shareholders, in addition to having a considerable impact on a company's financial resources. The adjustment in the price of shares and the cost of issuing additional equity has to be borne by the company. This is particularly hard for smaller companies that are owned by family members who are the main investors. The adjustment in price is usually done through stock splits, declaring dividends and issuing bonus shares.

However, it is recommended that such adjustments should only be time-bound or made with respect to any additional shares issued within a certain time period, i.e. one year of the initial investment. The idea behind investment is to help a company grow and not to put a strain on its capital, and an acquirer or investor must assume some of the associated business risk.

Liquidation Preference

When a company's financial health is failing and a receiver has been appointed over its assets, the creditors are first paid their dues on a pro-rata basis and then an acquirer or investor holding preference shares is paid. When investors hold equity shares as well, they may be given preference in realizing their investments during liquidation

over the other shareholders, provided the other shareholders agree contractually to assume secondary status vis-à-vis the private equity investor or to forgo their rights.

Liquidation preferences are triggered upon liquidation and the appointment of a receiver for the assets, a substantial change or deviation from the company's core business activity, the sale of all or substantially all of the assets of the company, an acquisition, merger or consolidation.

Under any of these circumstances, liquidation preferences are ideally negotiated by a private equity acquirer or investor to ensure that they receive, at minimum, the purchase price back before other shareholders receive any returns on their equity. However, the terms of super-multiple participating liquidation preferences can entitle the acquirer or investor to receive multiple returns on the investment and, further, makes them eligible to participate with other shareholders in distributing the remaining assets on a pro-rata basis, thereby entitling them to realize dues and invested funds before other equity holders have any participation in the liquidation process.



**PRITI SURI & ASSOCIATES
LEGAL COUNSELLORS**

E-601, GAURI SADAN, 5 HAILEY ROAD, NEW DELHI – 1100 01, INDIA

PHONE: +91 11 2371 8520/ FAX: +91 11 2372 5914

E-MAIL: p.suri@psalegal.com/contact@psalegal.com

PSA is a broad-based full service Indian law firm based in New Delhi, India with a collective experience of five decades providing a range of legal services, both inbound and outbound for global corporations. Our core practice is focused in assisting multinational companies, in diverse industries, with their ventures, either green-field or existing, in India and representing Indian companies in their global activities. Ms. Priti Suri, the proprietor of the firm, has more than two decades of experience with Western companies while working as their business counsel.

The firm's capabilities extend to all practice areas including corporate, commercial law, intellectual property, arbitration and litigation, information technology, telecommunications, labour & employment, real property and cross-border transactions and M&As. Additionally, from start-ups to multinationals, the firm also represents clients in matters relating to regulatory approvals, outsourcing and taxation. PSA's advice encompasses all aspects of a client's business activities, be it joint ventures or cross-border M&A or ongoing commercial issues. An in-depth knowledge and understanding of the objectives and concerns of the client's businesses permits our lawyers to formulate creative solutions to difficult contractual, legal and business issues.

The firm's multi-lingual capabilities, alliances with other lawyers and firms, both in India and globally, provides it with a competitive edge and enables it to represent the legal challenges of the clients and deliver innovative solutions.

The core philosophy and ethics of PSA lawyers is rooted in delivering a personalized and an innovative service of the highest quality and in forging long-term relationships with clients while working as their business counsel.

For example, if a private equity investor negotiates a three-times-multiple on a participating liquidation preference in a US\$10 million investment for a 50% stake in a company that is subsequently sold for US\$40 million (or the money received by the liquidator pursuant to the sale of the assets of the company), the investor will be entitled to US\$35 million of the distribution of sale proceeds. The investor receives US\$30 million from the three times return on the investment and another US\$5 million from participating with the remaining shareholders in the distribution of the sale proceeds on a proportional basis of the shareholding.

In the interests of target companies, it is important to cap the sum a private equity acquirer or investor can receive during a liquidation or to provide that the liquidation preference shall not apply if the value of the company exceeds a certain amount. This ensures that the investor receives a healthy return while simultaneously preserving a meaningful return for the other equity holders.

Timely Redemption

An acquirer or investor normally wants the option to liquidate an investment at will, necessitating an effective exit mechanism to be in place. One of the advantages for the holder of preference shares is that they already come with a maximum redemption period of 20 years. Private equity investors are increasingly looking at investments with a mandatory redemption date that is no more than a few years after the investment. This can be achieved by the right to a put option, which may be exercisable after a specified period of time, requiring the company to return the investment (plus accrued dividends).

Agreements should have a fixed mandatory redemption clause of not less than five years, so as to allow the company enough time to execute its business model. The investor, by virtue of an agreement, should also be allowed to retain the option of continuing with the investment. The overall objective is to protect the interests of both the acquirer/investor and the target. But private equity investors who want a management role must realize that they have invested in the venture to make it work and have not merely extended a loan that they can cash out at will with favorable returns.

Private equity investors who want a management role must realize that they have invested in the venture to make it work and have not merely extended a loan that they can cash out at will.

India has become a hot destination for foreign funds, given its exemplary growth rate. Although investments always have risks attached, one can minimize these by making appropriate provisions at the time of executing the investment agreement. For an acquirer or investor looking to safeguard an investment, preferential shares are a better option than equity. The timely redemption of equity plays a very crucial role for private equity acquirers and investors, as traditionally they looked at investing huge amounts for the long term while seeking active management participation. On the other hand, small acquirers and investors, the number of which has mushroomed in India in recent years, look at a shorter span of investment (of up to five years) and, typically, are pure investors who do not seek active management in the companies. The amount they invest is also comparatively lower. Preferential shares not only ensure a regular dividend but are more lucrative for the future buyers who shall also be entitled to preferential benefits.

About the author

Priti Suri is the proprietor of PSA Legal. She has two decades of experience on three continents in diverse areas of international commercial law, mergers and acquisitions, joint ventures, technology transfers, and arbitration and litigation. After earning an LL.M. degree in the United States, she took part in the ABA's International Legal Exchange program and worked at law firms in the US. Based in Paris in the early 1990s, she returned to India in February 1997 to set up the practice in New Delhi. She continues to represent several clients in a broad spectrum of industry ranging from automobiles, defence, energy, information technology, infrastructure, pharmaceuticals and telecommunications.

The author is grateful to Adity Gupta for her valuable assistance in preparing this article.