Question lingers over status of pre-IPOs

By Priti Suri and Aditi Mohan, PSA, Legal Counsellors

PSA, Legal Counsellors
E601 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

India has become a hub for several young and fast moving companies with tremendous potential to achieve exponential growth.

However, most of them struggle during their infancy period.

Often, the main reason for the struggle is inadequate resources and a dearth of capital for sustainability and expansion.

The debt market, too, is hesitant to invest in these young companies due to uncertainties that this lack of access to capital creates and how it may impact future growth.

Therefore, in these circumstances, pre-initial public offering convertible bonds (pre-IPOs) have become an attractive source of funding.

Companies can use pre-IPOs to raise initial capital or capital for expansion while private equity (PE) investors can use them to invest in India, particularly investors looking to set up long-term relationships with forward looking companies that plan to issue publicly traded shares.

Unlike traditional convertible bonds, a pre-IPO is a security issued primarily to PE firms.

It is similar to a convertible debenture, which gives the PE investor a right to convert the bonds into equity at a predetermined price when a company goes public.

A company may structure its pre-IPO in a manner that some or all of the benefits attached to preference shares – for instance, participation in management, assured return on investment, preference in receiving proceeds from sale or liquidation – are allowed to the bond holder.

A company may also allow the issue of shares at a discount or issue bonus shares when it opens its initial public offering (IPO).

However, the convertible bond automatically converts into equity when a company issues shares through an IPO.

Different perspectives

The intent of a company behind floating a pre-IPO is to create a favourable environment for PE investors and to access their funds.

It is a cost effective mode for generating capital as compared to borrowing, which carries high interest rates.

Financing through convertible bonds instead of actual equity creates a product to satisfy the demands of a PE investor without any immediate dilution of the existing shareholder stakes.

A pre-IPO provides the PE investor the possibility of future growth with the debt component securing the investment.

Further, it allows them a guaranteed allocation of equity when the IPO opens, particularly for those PE firms that intend to remain long-term with the investee company.

Essentially, a PE investor will invest in this type of hybrid instrument in anticipation of deriving value from its equity conversion right.

If a company fails to float an IPO by a set date, the PE investor has an option to exit from the investment enabling him to protect his overall return.

Apprehension of SEBI

The Indian capital market regulator, the Securities and Exchange Board of India (SEBI), has taken a stern view of the pre-IPOs issued to PE investors.

SEBI considers them as pure "debt" and not equity because the companies do not fix the price of the IPO at the time of raising the "debt" and allow the PE investor to buy equity when the company goes public.

This creates a misleading impression in the mind of the public about the number of available equity shares.

However, this apprehension of SEBI seems to be ill-founded.

The SEBI (Disclosure and Investor Protection) Guidelines, 2000, describe the prerequisites of disclosing the risk factors attached with an IPO in the offer document made available to the public.

Any prudent investor, before investing, will ascertain the level of risk involved and make a decision to invest after ascertaining its individual exposure.

However, in order to alleviate concerns, SEBI is mulling over measures under which the companies intending to go public may have to fix their pre-IPO prices.

Easy and attractive

Pre-IPOs are a relatively easy mode for fund-raising and an attractive option for the PE investors.

In the recent past, various companies have resorted to this mode of financing.

In 2007, Indian companies have witnessed pre-IPOs mainly in the real estate, infrastructure and financial services sector.

However, in order to protect the interest of the PE investor there is still a need to streamline the pre-IPO process and exhaustive guidelines have to be prepared and implemented which must address the concerns of both the PE and public investors.

Priti Suri is the proprietor of PSA. Aditi Mohan is an associate.